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A financial review of the Navy exchange program : 1973 to 1978.

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A FINANCIAL REVIEW OF THE NAVY EXCHANGE PROGRAM: 1973 TO 1978.

Jeffrey William Schneider

NAVAL POSTGRADUATE SCHOOL
Monterey, California

THESIS

A FINANCIAL REVIEW OF THE NAVY
EXCHANGE PROGRAM: 1973 to 1978

by

Jeffery William Schneider

March 1980

Thesis Advisor: R. A. Bobulinski

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From the results of the financial analysis a number of general conclusions are drawn. Through this method of presentation it becomes evident that the NEX Program is currently financially sound, but not without problems. The discussion presented describes these apparently unfavorable indications and suggests that more detailed study be conducted to determine their impact on the future of the NEX Program.

A Financial Review of the Navy Exchange Program: 1973 to 1978

by

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Submitted in partial fulfillment of the requirements for the degree of

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March 1980

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I. INTRODUCTION

A. A PERSPECTIVE OF THE NAVY EXCHANGE PROGRAM

The worldwide military exchange system is an enormous network of retail store operations whose sales revenues in Fiscal Year 1978 were 5.4 billion dollars. The true magnitude of this rather impressive figure is known by few within the civilian or general military populace. Comparison to national rankings of comparable private sector operations reveals some rather startling statistics.

If compared with the nation's top retailers in 1978, the military exchange system's total sales would rank an impressive seventh position, behind such competition as Sears, K-Mart, Penney's, Woolworth's, Federated, and Ward's respectively. In sales per store, military exchanges would rank fourth with an average of 5.7 million dollars in annual sales per store; Sears, Wards and K-Mart occupying the first three positions.[1]

The Navy Exchange Program represents approximately twenty five percent of the total military exchange sales. Its annual sales have exceeded a billion dollars every year since 1974. Generating its revenues through an expansive aggregation of retail outlets and a multiplicity of service centers, the Navy Exchange Program has become "big business." As a big business operation, it is equally susceptible to the many pitfalls and shortcomings of its private sector competitors as well as the advantages of economies of scale.

B. SUBJECT AREA OF RESEARCH

Individual investors or business enterprises seeking to improve their financial well-being frequently turn to investing in another enterprise to accomplish this objective. Before venturing into this type of investment, however, most subscribe to the financial analysis of the investment firm's operating performance over an extended period of time. Though a most recent successful performance is an encouraging indicator, a long-term evaluation is normally needed to provide reasonable assurance that the firm is a viable operating concern with good potential for future earnings and growth.

Though the Navy Exchange Program does not afford individuals or organizations the opportunity to invest in the equity of the organization, of all operational entities within the Navy, it has a striking resemblence to private sector, profit oriented enterprises. Thus, it seems reasonable that many of the fiscal characteristics of performance common in private retail enterprises should be present in the operation of the Navy Exchange Program.

With this in mind, the author approached management at Navy Resale headquarters to determine if a study from this perspective had ever been conducted. Though examination and evaluation of the exchange program is accomplished on a continuing basis, including audits by independent accounting firms, there apparently has never been a detailed evaluation of financial performance from a "prospective investor's" viewpoint.

C. OBJECTIVES

With the current rumblings regarding possible mismanagement and corruption existing in the Navy Exchange operations[2] and continuous Congressional pressure to reduce these operations, the author concluded that a close look at the financial performance of the exchange program might prove enlightening. As Congressional and other Government agency interest surrounding the corruption allegations continues to build, it seems appropriate that those internal to the organization would be so moved to conduct detailed evaluations of various levels of the exchange program hierarchy.

By applying various tools and techniques of financial statement analysis common in private industry to the Navy Exchange Program, the author's main objective is to provide a reasonable appraisal of the current financial condition of the program. In conjunction with providing a current "snap shot" of the operations, the author intends to present an evaluation of performance over the period 1973 to 1978, highlighting those trends which are significant indicators for the future viability of the Navy Exchange Program.

D. APPROACH AND METHODOLOGY

The general approach to be utilized in the research is to apply the fundamental tools and techniques of private sector financial evaluation and analysis to the Navy Exchange Program. Through the use of comparative financial statements, index-number trend series financial statements, funds

flow and in-depth financial ratio analysis, the author will provide discussions regarding the Navy Exchange Program's financial performance in six basic categories. The categories to be utilized include short-term liquidity, funds flow, capital structure and long-term solvency, return on investment, asset utilization, and operating performance.

The research was divided into three areas:

1. literature research,

2. data collection (actual audited financial statements of the Navy Exchange Program, operating statements, long-range planning documents, project budgets and other financially related documentation), and

3. interviews with the Navy Exchange Comptroller, and other operational personnel both at the field (store) and headquarters level.

This research was supplemented by the author's first hand experience in the Navy Resale System which includes managing a ship's store afloat and a Navy commissary store ashore as the Commissary Store Officer.

E. THESIS CHAPTER SUMMARY

The first chapter briefly introduced the magnitude of the Navy Exchange Program and presented the impetus for the research. It also delineated the author's objectives and research methodology.

Chapter Two provides the reader with a broad background of the Navy Exchange Program including a detailed definition

of an exchange; the evolution of the program; its missions, organization and policy guidance; and the dissimilarities of exchanges from private sector enterprises.

Chapter Three provides the details of the analysis conducted. It commences with a discussion of the methodology of the analysis followed by an overview of the financing characteristics of the program. The data is presented, the tools and techniques are applied in a quantitative analysis, and a detailed discussion is offered in the six aforementioned categories of evaluation.

Finally, in Chapter Four, the author summarizes the significant findings regarding the financial condition and trends of the NEX Program. Conclusions are drawn from interpretation of the data and quantitative analysis; and factors, which may have impacted the operating results, are discussed. The author also introduces and discusses the concept of real growth or constant dollar analysis in an abbreviated format. Recommendations are then made by the author, but no attempt is made to propose any policy or procedural changes in the operation or accounting of the Navy Exchange Program.

II. BACKGROUND

A. WHAT IS A NAVY EXCHANGE?

This, perhaps, appears to be a trivial question, yet, for those unfamiliar with the military environment, it is a very pertinent question which must be briefly addressed. It should be noted that each military service has an exchange program and the description provided herein is basically applicable to any of the other branches of the service.

The Navy Exchange Program is one branch of the total Navy Resale System. The other branches include Navy commissary (food) stores, ships stores afloat, and Military Sealift Command exchanges. Simply stated, the Navy exchange is the Navy's version of the retail discount or department chain store and its associated services. Though its operation and mission differ from the commercial sector, it appears to function like any of the major retail chain stores familiar to the civilian community. The Navy Exchange Manual provides the following amplifying definition:

> All authorized exchange activities, which function within a single command and which are operated administratively as a single enterprise, will be known as an exchange. The term "exchange" is used here in a broad sense and includes the operation of all the retail and service departments authorized ... The exchange will be operated under a single command and may be a main, branch or location, and will provide within in its own framework the maximum facilities and services required for naval personnel and their dependents.[3]

Though the exchange program today is a huge business enterprise, its beginning was remarkably modest.

B. EVOLUTION OF THE NAVY RESALE SYSTEM AND THE NAVY EXCHANGE PROGRAM

The tradition of sea-going officers specially trained to manage the business affairs of ships dates back to the eleventh century when British agents called clerks or pursers were responsible for the complete fitting-out of vessels in the service of the King. These clerks were of questionable integrity in the eyes of the British crews they served, who often felt they were being cheated in the purchase of necessity items. Such terms as, "purser's shirt," meaning a loose, poorly fitted garment, and "purser's candles," meaning the smallest possible candle, originated during this period.[4] Although modeled after the British system, the American Navy's pursers had a better reputation.

In 1794, the Naval Armament Act provided a billet allowance of one purser for each new ship. The American purser was to be the rank of Warrant Officer, and have responsibility for feeding, paying, and selling clothing items to the crew. The pay was established at forty dollars per month plus two rations a day and allowances.[5] The allowances could be rather substantial as profit of ten to fifty percent on goods sold to the crew was legal.

As the size of the United States Navy increased, the purser's responsibilities grew as well. An ability to speak foreign languages, specifically French and Spanish, was

required to conduct business in foreign ports and regular audits conducted by the Treasury Department dictated some training in accounting. By the early 1800's, the pursers were given the rank and attendant status of Commissioned Officers, and the added responsibility of maintaining the ship's ammunition records as well as the muster records of the ship's officers.

In 1818, pursers were authorized shore duty for the first time at Navy shipyards with the added responsibility of paying and feeding all the officers and men plus Navy Yard mechanics and laborers. During this same period of time Naval storekeepers were allowed as assistants to the purser.[6] In 1842, the purser was established as a regular officer in the Navy during a major Navy reorganization. They were placed under the Navy Bureau of Provisions and Clothing and Congress established standard pay scales to replace the previous rations, allowances, and pay. This formal recognition of the position of Purser and the associated reorganization forbid Pursers to procure or dispose supplies to the officers and crew for personal profit. It was this action that finally quieted many of the complaints of exploitation by the Purser. A Captain's recreation fund was established and profits were now generated for the benefit of the entire crew.

In 1858, Pursers officially became entitled Paymasters and their responsibilities continued to grow. Inventories afloat were consolidated with those held ashore under the

General Storehouse System in 1886 and the Navy Stock Fund was created to be administered by the Paymasters. In 1892, the Bureau of Provisions and Clothing was renamed the Bureau of Supplies and Accounts and under the leadership of the Pay Corps took on the added job of accountants for the Navy.[7]

The Paymaster also assumed responsibility of managing the ship's canteen or slops-chest as it was sometimes called. These were cooperative ventures started merely by agreement between the captain and crew of the ship and were financed solely by the crew members. The Paymaster generally purchased stores on consignment and paid for them as they were sold. The frequent and irratic movement of ships made payment to the consignors very difficult and the frequency of unpaid bills became rather high. The failure to pay these bills reflected badly on the integrity of the Navy as a whole, despite the fact that the canteens were unofficial activities.[8]

Another source of merchandise was provided to the crew by "bumboat" men who did a substantial business selling, not necessities, but ice cream, baked goods, fruit, newspapers, and knicknacks of every description. Whenever a ship neared port these peddlers put out into the harbor with their boats loaded with merchandise, which they exchanged for the sailors' money. Many of these men were dishonest and frequently reaped exorbitant profits from the sale of goods which were poor in quality and high in price. The bumboaters were

generally considered a nuisance and a menace aboard ship. They were sometimes found to be dealing in illegal goods or arranging for "immoral services."

> The unsatisfactory nature of the unofficial canteens and the unsavory character of the bumboaters could not be tolerated indefinitely, but, if they were eliminated, sailors would have no source for their personal merchandise requirements. It was with these considerations in mind that the first ships stores were officially established.[9]

Legal status was given to the Navy ship's stores by the Naval Appropriation Act of March 3, 1909. This act carried the following clause:

> Hereafter such stores as the Secretary of the Navy may designate, may be procured and sold to officers and enlisted men of the Navy and Marine Corps, also to civilian employees at Naval stations beyond the continental limits of the United States and in Alaska, under such regulations as the Secretary may prescribe.[10]

During July of 1909, the Secretary of the Navy (SECNAV) formally established ship's stores, listed the articles which might be sold, and placed a limitation on the value of inventory which would be allowed. A month later SECNAV more clearly defined the purpose of ship's stores as the purchase, at the lowest market prices, and the sale at a resonable cost to enlisted personnel, of articles considered necessary for their comfort and contentment. The questions of profits under the official ship's stores and the distribution thereof soon had to be faced. In 1910, Congress limited profits to a maximum of fifteen percent and specified their

use for recreation and welfare of enlisted personnel with control administered by the Bureau of Supplies and Accounts.[11]

During and immediately following World War I, it became apparent that not only did the ship's stores fail in the mission to provide commodities and convenience, furthermore the stores did not produce sufficient revenue for financing the ship's welfare requirements.[12] From this a new operation developed known as the ship's service, which included the ship's laundry, barber shop, cobbler shop, tailor, presser, and photographer. Like the old canteen it was cooperative in nature. The ship's service operation soon opened another retail store on board, a ship's service store vice a ship's store, which carried virtually any legal article of merchandise and could make whatever profits were needed by the individual ships. These were in competition with the existing ship's stores aboard ship and without legal foundation.

The ship's service stores were given official sanction by Navy Regulations in 1932 and placed under the administration of the Bureau of Navigation.[13] The Bureau of Supplies and Accounts, responsible for the ship's stores, was in no way connected with the operation of the ship's service activities. During this same time frame, similar kinds of stores and services had come into being at shore establishments. These activities, however, caused little concern as they were viewed as the counterpart to the Marine Corps and Army Post Exchanges. The conflict of ship's store and ship's service

stores afloat was, however, of great concern to the Bureau of Supplies and Accounts.

By the late nineteen thirties, the ship's service activities and ship's stores had become so extensive that their space and weight requirements afloat became a serious problem for fighting ships. The management of the operations required the assignment of line officers, both afloat and ashore, which, because of the inventory and accounting requirements of the operations, should logically have been supervised by the Supply Officer. However, because ship's service stores were unofficial resale activities, supply officers were not allowed to be involved with them.[14]

The outbreak of World War II found extensive duplication of goods and services in the afloat stores. There seemed little logic in allowing for this practice to continue, particularly in view of the expanded new construction program, with space a premium. In addition to this, there were no funds available for establishing ship's services on newly commissioned ships. After various studies and reports, in October 1944, SECNAV merged the ship's stores and ship's service stores on vessels having Supply Officers. A Ship's Store Division of the Bureau of Supplies and Accounts was established to offer supervision, formulate policies and provide guidance for these stores. The Ship's Store Division was big business, but an even bigger and uncontrolled business was flourishing in the ship's service stores ashore.

In May 1945, the Secretary of the Navy appointed a committee to study Navy resale activities. The committee was composed of Navy Reserve Officers who had national reputations in civilian retail operations. The chairman of the committee was Captain Wheelock H. Bingham, SC, USNR, who later became President of R.H. Macy and Company, Incorporated.[15] The Bingham Committee recommended that Navy resale activities be consolidated into a system under which they would be operated like a large chain of retail stores receiving central direction and guidance from a headquarters office. The committee's recommendations were approved by the Secretary of the Navy and all resale activities were placed under the cognizance of the Bureau of Supplies and Accounts. On 1 April, 1946, the Secretary of the Navy established in New York the Navy Ship's Store Office as the headquarters office over ship's stores afloat and ship's service stores. This action marked the beginning of the Navy Resale System as we know it today.

In 1949, responsibility for technical guidance and assistance to ship's stores afloat was added to the Navy Resale System mission, and the functions of the Bureau of Supplies and Accounts' Ship's Store Division, established in 1944, were transferred to the Navy Ship's Store Office. In 1950, Military Sealift Command exchanges were included in the Navy Resale System mission. Also in the early fifties, to eliminate some of the confusion concerning names of the various resale operations, ship's service stores were redesignated as Navy

Exchanges (NEX) and the remaining ship's stores ashore became Commissary Stores.

Commencing from the early nineteen-fifties, a significant amount of change has taken place in the Navy Resale System programs, functions, and control. Chronologically, the most significant are:

1952 - The establishment of the West Coast Branch office to provide field assistance to activities in the Western Naval districts and the Pacific area.

1957 - The Navy Resale System commenced financing the construction of new exchange facilities as a supplement to military construction funding.

1960 - The operation of the Naval Uniform Shop was added to the Navy Exchange Program.

1961 - Enlisted clubs, guest houses, and locker clubs were added to the Navy Exchange Program.

1964 - Management control of Navy and Military Sealift Command exchanges was relinquished by the Navy Resale System in accordance with a revision of General Order 19 and was returned to Commanding Officers as a function of command.

1967 - Command of commissary stores was assigned to the Navy Resale System in order to provide strong centralized management of these store operations.

1969 - The Navy Ship's Store Office was renamed the Navy Resale System Office.

1970 - The Navy Lodge Program was launched and management of the lodges was added to the responsibilities of the Navy Exchange Program.

1976 - The Retail Clothing Stores (Small Stores) were integrated with the Navy Exchange Program. Also, in 1976, management control over enlisted clubs was placed under the cognizance of the Bureau of Naval Personnel.

1979 - The Navy Clothing and Textile Facility and the Navy Food Service Systems Office were transferred to the Navy Resale System. Once again the headquarters office was renamed; this time to the Navy Resale and Services Support Office (NAVRESSO).

The Navy Resale System has grown into a large, worldwide business. It is a highly diversified system of retail stores and service centers. The expansiveness of the system is often not realized until it is statistically presented. At the beginning of fiscal year 1979, the Navy Resale System consisted of the retail stores and service activities enumerated in Exhibit II-1. These activities generated sales revenue in fiscal year 1978 of 1.7 billion dollars,[16] of which over 1.1 billion dollars was from the exchanges and their associated service outlets. When comparing this total sales figure to the Fortune Magazine sales ranking of the nation's top retailers, the Navy Resale System ranked a very respectable thirtieth position. Be that as it may, the true measure of the "worth" of the Navy Resale System is in fulfillment of its specified mission.

C. THE MISSION OF THE NAVY EXCHANGE PROGRAM

The review of any large business organization requires initially that its reason for existance be established so

RETAIL STORES AND SERVICE CENTERS OF THE NAVY RESALE SYSTEM, JANUARY 1979

1) 146 main retail stores

2) 175 auto service centers

3) 915 food service operations including cafeterias, mobile canteens, and snack bars

4) 326 beauty and barber shops

5) 60 laundry and dry cleaning facilities

6) 37 Navy lodges

7) 83 commissary stores

8) 342 ship's stores

9) 2 Military Sealift Command Exchanges and

10) many other service operations such as car rental agencies, flower and optometry shops, portrait studios, and of course a worldwide catalogue mail order service.[17]

EXHIBIT II-1

that appropriate measures of effectiveness may be applied. Perhaps the broadest categorization utilized is the distinction of "profit-oriented" versus "non-profit."

> The dominant purpose, or at least one of the major purposes, of some organizations is earning profits. Decisions made by their managements are intended to increase (or at least maintain) profits, and success is measured to a significant degree by the amount of profits that these organizations earn ... By contrast, other organizations exist primarily to render a service. Decisions made by their managements are intended to result in the best possible service with the available resources, and their success is measured primarily by how much service they render and by how well they render it.[18]

The difference in purpose is not easily discernible in all cases. Some organizations perform in a manner characteristic, to varying degrees, of both categories. The Navy Exchange Program mission statement is an example of this hybrid characteristic.

> The mission of an exchange is to provide a convenient and reliable source from which authorized patrons may obtain at the lowest practicable cost, articles and services required for their well-being and contentment; to provide, through profits, a source of funds to be used for the welfare and recreation of Naval personnel; and to promote the morale of the command in which it is established through the operation of a well managed, attractive and serviceable exchange.[19]

There are three very distinct mission elements addressed in the above statement and the Navy Resale System has expanded on them somewhat in their current five year operational plan. The first element is defined as "Service and Patron Savings." It amplifies the quoted mission statement as follows:

> Provide goods and services to the maximum number of authorized patrons and their families at the lowest practicable cost and at reasonable patron savings in comparison with the private sector.[20]

The second element of the mission statement has been titled "Profits and Efficiency." It too is expanded and provides a broader perspective of the profit making objectives of the system.

> Achieve planned Navy exchange contributions to Morale, Welfare and Recreation programs in consonance with accomplishing the service and patron savings objective and ensure the efficient, productive, and effective operations of all Navy Resale System echelons.[21]

The third element of the Navy Exchange (Resale) mission is terse and to the point. It is defined as "Facilities and Resources."

> Provide convenient attractive facilities and the personnel and financial resources necessary to maintain system viability.[22]

Aggregating the Navy Exchange Manual definition with the expanded descriptions presented in the five year operational plan leads the author to the conclusion that the NEX Program is definitely not a "profit-oriented" organization in the traditional sense of the definition. It does, however, have profit making objectives which are vital to the fulfillment of the overall mission. It is a "non-profit" organization which requires minimum revenues above operating costs to fulfill its mission.

D. ORGANIZATIONAL STRUCTURE OF THE NAVY EXCHANGE PROGRAM

To describe in detail the organizational structure of the Navy Exchange Program, it is best to initially establish the relationship of the Navy Resale and Service Support Office (NAVRESSO) to the Department of the Navy. Exhibit II-2 provides the overall lines of command and support.

Organizationally, the Navy Resale System is a component of the Naval Supply Systems Command. The chain of command extends from the Office of the Secretary of the Navy through the Chief of Naval Operations and Chief of Naval Material, as shown by the solid lines. This chain of command includes all areas of NAVRESSO responsibilities, the Navy Exchange Program being but one such responsibility.

The relationship of NAVRESSO to the individual exchanges is also presented in Exhibit II-2 and is graphically represented as a broken line, which indicates a support relationship. This is perhaps the most significant and operationally impacting characteristic of the NEX chain of command. This organizational line of support ties directly to the commanding officer (CO) of the activity and the Navy Exchange Officer (NEO) with the line of command directly between the CO and the NEO.

NAVRESSO primarily provides specialized guidance and support to its exchanges. Budgeting and fiscal guidance are provided through directives and instructions as are new policies and other procedural changes. The support provided

LINES OF COMMAND AND SUPPORT
NAVY RESALE AND SERVICES SUPPORT OFFICE

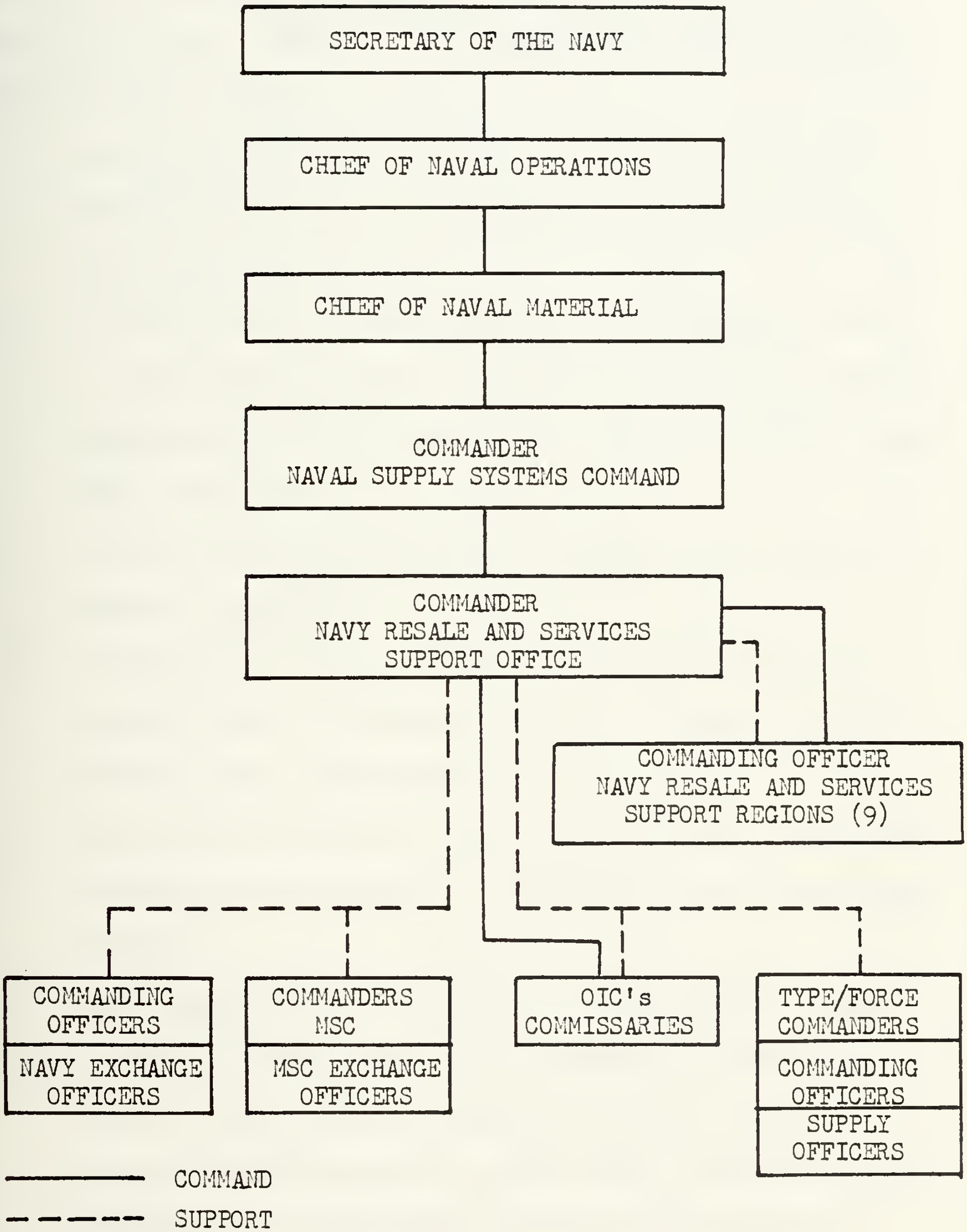


EXHIBIT II-2

takes on many forms. Exhibit II-3 graphically presents the internal organizational structure of NAVRESSO as well as detailing the expansive support network it provides all resale activities. Some of the support services provided to the exchanges are:

1) Centralized accounting on a worldwide basis and preparation of monthly financial statements for each local exchange;
2) Preparation and distribution, on a biweekly basis, of paychecks for over 20,000 civilian Navy exchange employees in the fifty states, Bermuda, Puerto Rico, Japan, and Guam;
3) Controlling worldwide self-insurance and employee benefit programs;
4) Merchandise price agreements and contracts with manufacturers are negotiated at NAVRESSO for direct order by Navy exchanges;
5) Analyzing and monitoring of all aspects of exchange merchandise management, including actual operational results;
6) Development and maintenance of operating manuals;
7) Planning, coordination, and centrally funding the cost of refurbishment and construction of Navy exchange facilities, the cost being capitalized at NAVRESSO and depreciated against the individual exchanges;

NAVY RESALE AND SERVICES SUPPORT OFFICE
(NAVRESSO)

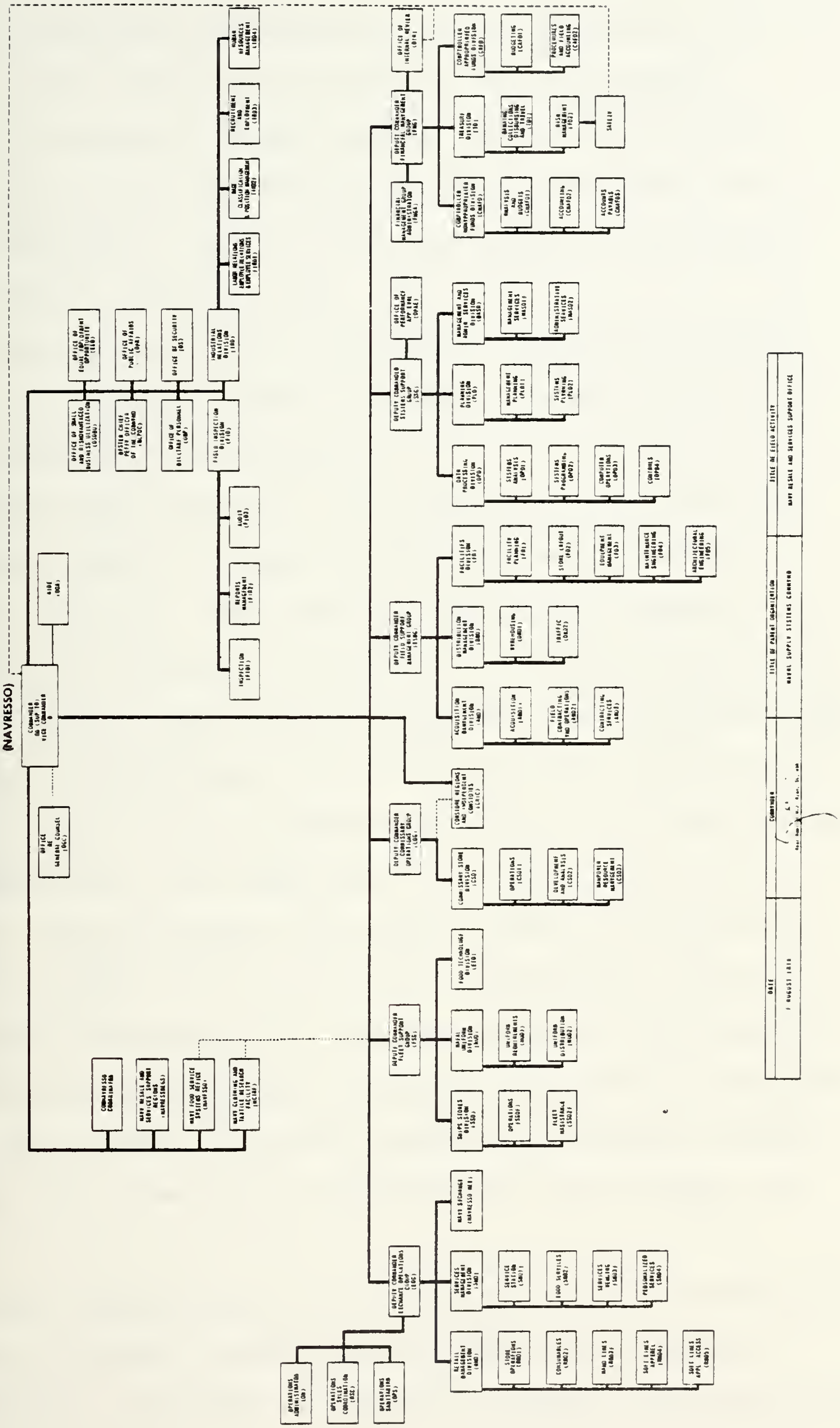


EXHIBIT II-3

8) Purchasing most equipment for exchanges and providing assistance in store layout and display;

9) Conducting training classes for civilian managers of exchange departments and providing input for the training of NEO's at the Navy Supply Corps School, Athens, Georgia; and

10) The conducting of inspections, operational audits and internal reviews, and the furnishing of on-site assistance when required.[23]

As previously mentioned, the NEO falls within the base commander's chain of command as does the entire activity exchange operation. The expansiveness of each exchange organization is primarily determined by volume of sales and physical layout. Geographical location, i.e., overseas, also can significantly impact the structure of the organization. Exhibit II-4 is a basic organization chart for a main exchange.

NAVRESSO has also established five Navy Exchange Complexes. These complexes are support centers that provide common services such as accounting, procurement, personnel management and warehousing. The consolidation of these services enables the exchanges to reduce the number of personnel at the store level and allows the NEO and exchange managers to focus more attention on merchandising and customer service.

A last consideration in the organization structure of the program is the Navy Resale and Services Support Regions (NAVRESSREG). NAVRESSO is currently pursuing the establishment

BASIC ORGANIZATION CHART - MAIN NAVY EXCHANGE

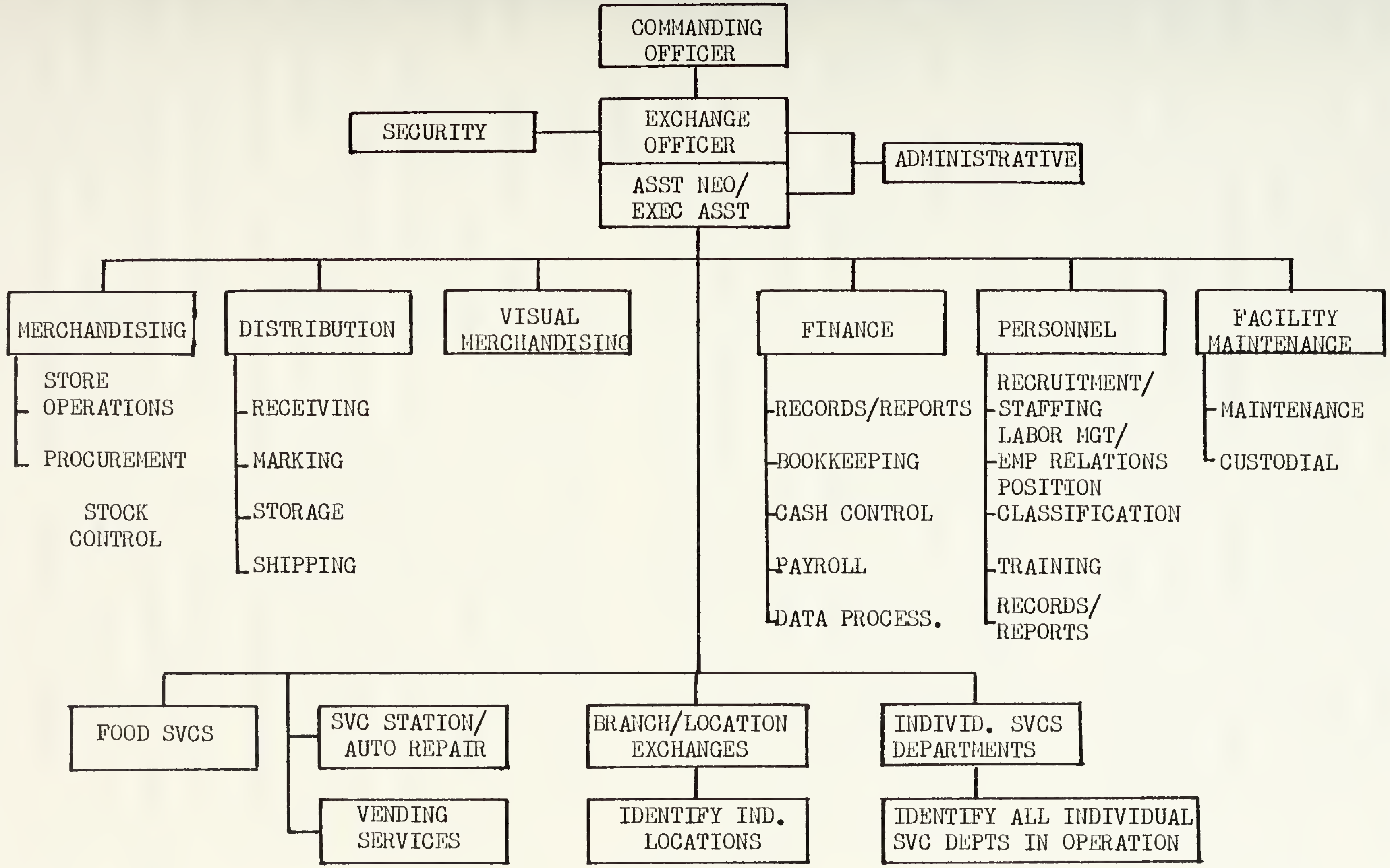


EXHIBIT II-4

of nine Field Support Offices, one in each NAVRESSREG, to provide support, centralized distribution and technical assistance to designated commissary stores and Navy exchanges in various geographical locations. Exhibit II-5 displays the line and support relationships of the regional offices as well as detailing, more specifically, some of the additional services to be provided.

E. POLICY GUIDANCE IN THE NAVY EXCHANGE PROGRAM

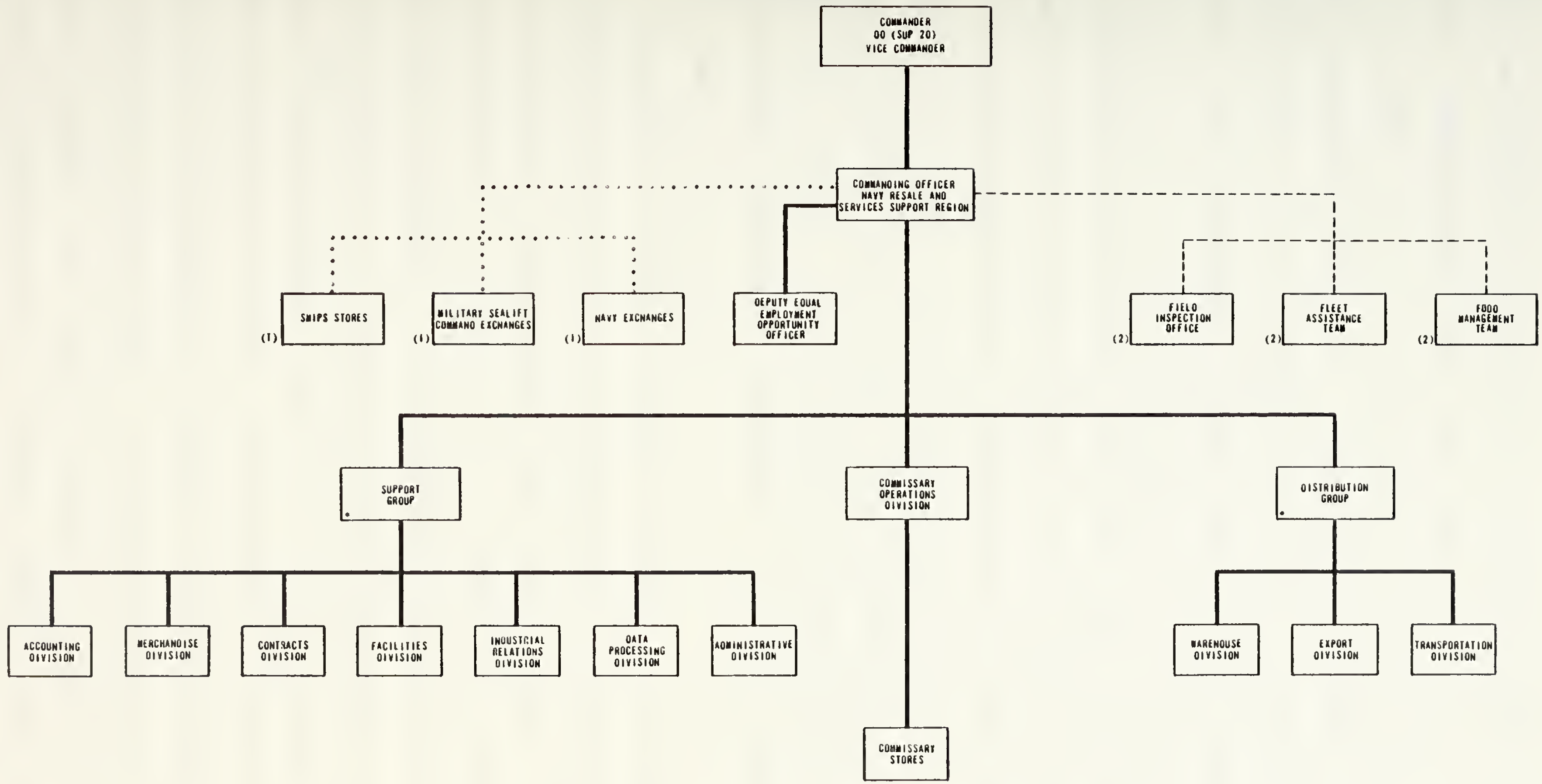
Policy guidance for the Navy Exchange Program is generated from a variety of sources, the primary source, Congress, being universal to all services. The Navy looks to three additional significant sources; the Navy Resale System Advisory Committee, local Exchange Advisory Boards, and the centrally managed Consumer Research Program.

1. Congress

Congress is a principal source of policy for all military exchanges, and is showing increased interest in all military resale activities. In 1949, the House Armed Services Committee established regulations for all military exchanges and commissary stores operating in the continental United States. The Committee, through hearings over many years, suggested, and the Department of Defense accepted, a list of authorized resale items. The authorized list of resale items for exchanges as well as the specific regulations for exchanges were incorporated into and published as the Armed Services Exchange Regulations (ASER) in January, 1949.

NAVY RESALE AND SERVICES SUPPORT REGION

(NAVRESSREG)



(1) RECEIVE TECHNICAL DIRECTION AND SUPPORT FROM NAVRESSO
(2) ATTACHED FOR ADMINISTRATIVE SUPPORT; RECEIVE DIRECTION FROM NAVRESSO

*SUPPORT AND DISTRIBUTION GROUPS PROVIDE SUPPORT FOR BOTH NAVY EXCHANGE AND COMMISSARY OPERATIONS.

EXHIBIT II-5

The ASER was updated and reissued in January, 1956, with only minor changes made since that time.

The ASER specifies the governing policies for all military exchange operations. As already addressed it defines and limits the merchandise that can be carried by an exchange in the continental United States in the authorized resale items list. Overseas exchanges are not covered by these merchandise restrictions but must comply with balance of payments criteria established by the Secretary of Defense.[24] Some of the other operational policies and instructions specified in the ASER include organizational structure of exchanges, external and internal audit procedures, methods of operation, general pricing policies, financial and uniformed personnel support of exchanges, state tax regulations, and procurement restrictions.

Besides the formal guidance provided in the ASER, the House Armed Services Committee significantly impacts policy through statements issued during Committee hearings. The Committee controls the mission of the exchanges to some extent through these statements. The Committee stated that it was and would continue to be concerned with competition with local merchants,[25] that exchanges should not be the sole provider of goods and services for the serviceperson,[26] and that the exchanges were not expected to supply the total amount of funds needed for recreational and welfare activities.[27] By inference it stated that Congress expects to appropriate recreation and welfare monies through specific line items

in the budget.[28] Statements of this type provide a subtle basis from which the respective services formulate their own policy guidance.

2. Navy Resale System Advisory Committee

Aside from Congress and its associated formal and informal policy guidance to the military exchange system, another major source of policy guidance for the Navy programs is the Navy Resale System Advisory Committee. Established concurrently with the Navy Resale System in 1946, by the Secretary of the Navy, the Committee was given the following mandate:

> Develop policies governing the organization and operation of the Navy Resale System Office, Navy exchanges, ship's stores and Navy commissary stores and make recommendations to the Secretary of the Navy with respect thereto...[29]

Since its creation, the Committee has recommended basic policy and the general course of the entire Navy Resale System. It has appraised the adequacy of overall operations and has assured effective use of the system's assets. In this context, it is very similar to that of a Board of Directors in the corporate world.

The Commander, Naval Supply Systems Command has been designated by the Secretary of the Navy to be the permanent Committee Chairman. Members of the Committee are designated by the Secretary of the Navy as well, generally upon recommendation of the current members, on the basis of stature in their respective fields and a desire to contribute to policy

direction of the Navy Resale System. The functional areas from which the organization structure currently provides its membership of seven are:

a. Retailing - General Merchandising

b. Retailing - Chain Store Merchandising

c. Grocery/Supermarket - Large Chain Operation

d. Financial or Investment Institution

e. Two "at large" members to round out requisites in functional areas.[30]

To establish the magnitude of professional expertise represented by the Committee, its current membership includes Mr. Richard M. Paget, founder and president of the management consultant firm of Cresap, McCormick and Paget; Mr. Edward E. Carlson, Chairman of UAL, Inc. and United Airlines; Professor Milton P. Brown, the Lincoln Filene Professor of Retailing, Harvard Business School; Mr. James W. Button, Special Assistant to the Chairman and formerly Senior Executive Vice President of Merchandising and a Director of Sears, Roebuck and Company; the Honorable Charles F. Baird, President of the International Nickel Company of Canada, Ltd., and formerly the Assistant Secretary of the Navy for Financial Management; Mr. William J. Johnson, Vice Presidnet, Business Planning Division of Superx Drug Corporation; and Mr. John O. Whitney, President of Florafax International.

The Committee meets semi-annually. A comprehensive agenda is prepared which includes an update on operations,

progress reports on new programs, and new proposals regarding system objectives, policies, organization, and operations. The Committee evaluates those proposals in light of their broad knowledge of practices followed elsewhere and provides an impartial, detached, analytical viewpoint in resolving problems and recommending an appropriate course of action. Committee recommendations are then submitted to the Secretary of the Navy for approval. The counsel and guidance provided by the Committee are considered a major contribution to the vitality of the entire Navy Resale System.[31]

3. Navy Resale System Consumer Research Program

To further mission performance of Navy exchanges, and commissary stores as well, NAVRESSO is actively involved in a consumer research program to keep management informed as to prevailing attitudes, needs, and concerns among all segments of its patron population. This research program is a recent innovation at NAVRESSO. Initiated in 1971, it resembles programs in the commercial sector which have been providing management there with market and customer information for a number of years.

Perhaps the most comprehensive and worthwhile research effort in the Consumer Research Program is the Patron Attitude Surveys of Navy exchange and commissary store customers. The surveys are designed to generate basic information feedback from the exchange and commissary store patrons. Of particular interest to NAVRESSO are (1) the patrons' expressed opinions on the importance of exchange and commissary store

shopping privileges; (2) the levels of satisfaction or dissatisfaction with merchandise, product selection, quality and price; (3) use and satisfaction or dissatisfaction with Navy exchange service facilities; and (4) the shopping and buying patterns and preferences of the stores' patrons. The results of these surveys are utilized by NAVRESSO to direct management attention to those areas presented as problem areas. Appendix A provides a brief summary of a recent survey.

An outgrowth of the patron surveys was the initiation of in-store patron interviewing for use by individual Navy exchanges. The program is designed to assist Navy Exchange Officers and merchandise managers in pinpointing the needs and preferences of their particular patron population. This provides local exchange management with a direct means of communication with the customers. Through this effort locally and with the information provided from the system surveys, Navy exchange management can better formulate its policies to fulfill its mission objectives.

An additional responsibility of the Consumer Research Program related to policy and mission is the Navywide Retail Price Comparison Survey Program. This program, developed in 1972, involves conducting semi-annual retail price comparison surveys for both Navy exchanges and commissary stores. The principal purpose of the surveys is to identify the "real savings" available to authorized patrons by comparing exchange

and commissary prices with prices found in civilian stores, disregarding tax savings considerations. The results of the surveys are the statistical measure of the direct contribution being made by Navy exchanges and commissary stores to the economic well-being of Navy personnel and their families.

4. Navy Exchange and Commissary Store Advisory Boards

One additional organization that certainly contributes to the formulation of policies and procedures, particularly at the local level, is each respective command's Navy Exchange and Commissary Store Advisory Board. Established in 1971 by Chief of Naval Operations directive,[32] each board consists of various patron and command representatives including the NEO and the Commissary Store Officer (CSO). It serves as a sounding board to better gauge customer desires and opinions and affords the Board members the opportunity for direct, two-way communications regarding problems or proposals. Through feedback from the local boards, NAVRESSO can many times identify system-wide or reoccurring problems and can initiate corrective action on a system-wide basis if the situation warrants. The board also provides the same opportunity to the local NEO, particularly in regards to the out-lying service operations. Minute changes in local policy can have resounding effects on the image of the operation as a whole.

F. DISSIMILARITIES OF THE NAVY EXCHANGE PROGRAM AND COMMERCIAL ENTERPRISES

The preceding sections have described in some detail various aspects of the structure and operation of the Navy

Exchange Program. Much of what has already been presented highlights various similarities and dissimilarities between the operation and management of exchanges and like commercial retail stores or organizations. Before delving into an in-depth analysis of the financing of the NEX program, it will be worthwhile to identify additional idiosyncracies of the program. The author considers these to be the most noteworthy in comparison to the private sector as well as having the most significant impact on the overall success in fulfillment of the NEX mission.

1. Patronage

The most obvious and perhaps most significant idiosyncracy of the military exchange program is its limited patron base. With fiscal year 1978 estimates of authorized exchange shoppers being 9.2 million (active duty Navy and dependents are only 1.1 million),[33] the exchanges have a very small available customer population compared to their civilian counterpart. Because this patron base is so restrictive, exchanges find themselves in a very one sided competiton for the patronage; one sided in that the private sector may lure the exchange patron out of the exchanges, but, the exchanges do not have a reciprocal opportunity. Exchanges cannot lure unauthorized members of the civilian community into the Navy stores.

Reduced military personnel and strength has been an increasing constraint on the exchange patronage as well. Even

major redistribution of forces, though not changing the overall patron base, can significantly impact existing or potential sales opportunities. The phasedown of military activities in the Pacific Ocean area after Vietnam is a good example of this. What with the reduction of deployed units as well as the reduced income of the remaining deployed personnel through loss of hostile fire pay and the tax exemption on pay, the overseas exchanges found their historically excellent sales become very slow and sluggish.[34]

A discussion of the effects of the limited exchange patronage would not be complete without at least mentioning the effects of inflation and pay related legislation. The loss in average military disposable income from January, 1972, to May, 1979, was 14.3 percent.[35] This reduced real income has left the patron with two basic options; develop a more frugal lifestyle, or resort to the credit opportunities existing in the civilian retail trade.

2. <u>Credit Sales</u>

Credit, as an optional purchasing method, has in the past not been available to the military exchange patron. During the past decade of rapidly increasing inflation, the American public in general turned to more extensive use of credit as a means of confronting this inflation. The exchange patron simply could not do this within the military's retail framework. This must certainly have had an impact on the total revenues and profits generated by the exchanges. Credit

was, however, discussed at length as an option to be utilized in view of the high patron interest.

The military services, as a result of information feedback from various boards and committees, informally surveyed patrons in 1975 and 1976 and found that the majority of customers polled wanted to be able to use credit cards in the exchanges.[36] This was given serious consideration but was ultimately ruled out because (1) on the basis of military pay, national credit cards would not be available to all patrons, and (2) to implement a worldwide military credit card system was simply too complex and too expensive.[37] The use of some other form of credit, however, was still considered favorable. Continued efforts to provide an equitable credit system for all patrons has resulted in what the Navy calls the "deferred payment plan." This plan, currently being tested at the Yokosuka Navy Exchange, is initially designed to improve the buying power and ease the financial burden being experienced by customers overseas.[38] The plan has some particular merchandise restrictions, but otherwise, it is very similar to other commercial credit programs; having individually established credit limits and a finance charge, currently twelve percent, on the unpaid balance each month. The Army and Air Force Exchange System (AAFES) has had four bases in Europe extending credit on a test basis since early 1978.

Establishing the program in the overseas exchanges was predicated, not only on income considerations, but also

on the type of merchandise available to patrons in the overseas stores. High price tag items such as major household appliances and home furnishings, not authorized in CONUS exchanges, are available to the overseas patron. The deferred payment plan is designed to help those in the lower pay grades afford these items which would otherwise be outside their financial means.

The results of this test will be monitored closely. Expansion into other overseas Navy exchanges is currently planned pending successful results from the test program. Any consideration of expanding the program into CONUS exchanges is currently unpublished.

3. Merchandise Restrictions

One of the most observable differences between exchanges and civilian stores, from the patrons' viewpoint, is the lack of certain types of merchandise. This problem is most prevalent in the CONUS exchanges. As discussed in the policy section, the ASER specifies the authorized merchandise list for CONUS exchanges and Congressional approval is required to modify the list.

The ASER disallows, through lack of inclusion, many types of merchandise which are commonplace in most department and discount stores. Consequently, the CONUS Navy exchange patron must shop elsewhere to find major household appliances such as washers, dryers, refrigerators, and microwave ovens; television sets; individual components for stereo

systems; and major household furnishings. Many of these items are considered necessities to a family's household; others are desirable comforts. All are generally high priced items and their lack of availability in CONUS exchanges must effect the overall income picture for the NEX program.

4. Special Procurement Considerations

As an agency of the federal government, there are some particular procurement policies which apply to the NEX program that do not apply to the private sector. The first to be considered is the Small Business Program.

It is the policy of DOD to place a fair proportion of its total appropriated fund purchases with small business concerns. While the NEX program does not fall into the DOD mandatory Small Business Program because it is a non-appropriated fund activity, NAVRESSO policy states that:

> Every effort should be made to encourage participation by such small business concerns in procurements initiated by exchanges.[39]

Another procurement policy consideration is the Minority Business Enterprise Program. By definition, a minority business enterprise is a business, at least fifty percent of which is owned by minority group members, or in the case of publicly-owned businesses, at least fifty-one percent of the stock is owned by minority group members.

> Concession or other contractural arrangements, offering services not currently available under contract, shall be reserved for negotiation with those responsible concerns whose names are furnished by the Office of Minority Business Enterprise, or are developed by contracting officers.[40]

Prior to establishing any new services, however, permission must be requested from NAVRESSO.

To insure participation in and compliance with Department of the Navy objectives regarding small or minority business concerns, NAVRESSO has established a staff office, the Office of Small and Disadvantaged Business Utilization to develop and administer its program. This office is also responsible for monitoring the implementation of the program and providing the requisite reports. Its location in the organizational structure is visible in Exhibit II-2.

5. <u>Long Term Financing of Capital Improvements</u>

The financing of major projects in the NEX program is another area of disparity between it and the civilian sector. Though the method of funding is not unique to the exchange program, the constraint leading to its utilization is not experienced in the commercial sector.

The major projects of the NEX program must, for the most part, be fully funded from within the NEX organization. Profits retained for reinvestment in the program are virtually the only source of funds available for these types of capital improvement projects. NAVRESSO does not have the option of financing its construction program or facilities improvement program through bond or stock issues nor through borrowing from commercial sources.

Requesting funds through the Congressional Budget cycle as part of the Military Construction Appropriation (MILCON)

is an available option, however, because of the limited availability of these funds combined with the low priority given exchange construction in the MILCON program, few line items are contained in requests for MILCON funds.[41] The MILCON funds obtained since fiscal year 1972 amounts to $21.25 million[42] which is only 28.3 percent of the total funds invested in capital improvement projects since that time. These funds were limited to new base construction or restoration of facilities after catastrophic events such as fires or extreme weather damage. These restoration projects were not considered under the normal line item submissions for MILCON funds.

6. Retail Clothing Stores and Uniform Shops

The NEXs have a unique situation existing in the operation of the Retail Clothing Stores (RCS). Formerly called Small Stores and operated by the local command's Supply Department, the RCS operation consists of providing, as merchandise, "Navy Issue" clothing (clothing procured through appropriated Navy funds and appearing on the Navy Clothing List for Men and Women) and selling it at cost. The function of managing and operating the program is provided by the exchanges and costs associated thereto are in turn reimbursed to the NEXs from appropriated funds. The operational policy is to provide RCS items at cost, therefore no gross profit is planned. From an accounting sense, it is basically considered a break-even operation. From a merchandising point of view, the program presents a significant

opportunity loss in that the RCS merchandise not only consumes shelf space which could be utilized for profit generating merchandise, it also competes with it. The RCS operation, however, is consistent with the mission of the NEX program.

Uniform shops are also somewhat of a unique operation. Though there are civilian stores which specialize in uniform clothing items and accessories, very few, if any, retail department or discount stores in the private sector have a similar operation. Worldwide, uniform sales represent approximately two percent of the total NEX retail department sales which, in fiscal year 1978, amounted to $3.1 million[43], a substantial figure.

7. Interest Income

Similar to most large business enterprises, the NEX Program utilizes its available cash assets in generating interest income. In fiscal year 1978, this income amounted to nearly 3 million dollars and fiscal year 1979 income is expected to exceed five million dollars.[44]

The differences between the NEX Program and private enterprises exist in the vehicles utilized to obtain the interest income. Whereas the private enterprise can invest in virtually any type of interest earning (or losing) venture, the NEX investors are limited to interest earning programs which are fully collateralized.[45] This means, of course, no speculative types of investments may be made even though they may be consistently drawing higher rates of interest. The

disparity in the actual interest income the organization realizes on the bottom line of its operating statement, however, becomes significantly reduced when tax laws are considered.

8. <u>Taxes</u>

A very pronounced difference exists between the NEX Program and private enterprises in the effect of taxes realized by each.

> Exchange activities are instrumentalities of the government, deemed essential for the performance of governmental functions and are entitled to whatever immunities the Department of the Navy may have under the Constitution and statutes.[46]

The ultimate ramifications of this quotation are (1) exchanges, as integral parts of the Department of the Navy, are exempt from Federal Income Taxes; and (2) exchanges are exempt from all state and local taxes. This tax exemption on the income of the exchanges is one of the critical factors which assists in the exchanges being able to maintain their lower retail prices.

The NEX also benefits from exemptions on other taxes, such as property taxes, retail or other business license taxes, and motor vehicle registration fees. Though these exemptions do not equate to the savings realized from the income tax exemption, they are distinct advantages in relation to the private enterprise operation.

The NEX is also exempt from the handling of sales taxes.

> A state may not impose a tax, the legal incidence of which falls directly upon the Federal government or any of its instrumentalities. That means a

> state may neither require an exchange to pay a tax which is imposed directly upon it, nor require it to collect a tax imposed upon its authorized patrons ... A state may, however, validly impose a tax which affects the exchange only indirectly by increasing the cost of supplies (merchandise) that it purchases.[47]

It should be noted that states have been allowed to impose gasoline taxes on the exchanges as Congress has declared that they have the right to tax directly, when gasoline is for personal use of the exchange patron. The last portion of the above quote simply means that suppliers, which have assumed the legal incidence of a state tax, may pass the burden of this tax to the exchanges by increasing the cost at which it provides its merchandise or supplies. As this type of tax is part of the NEX cost price, the ultimate bearer of the burden is the exchange patron.

There are a variety of taxes which do apply to the Navy exchanges either directly or indirectly. The Navy Exchange Manual fully specifies the tax liabilities which apply to the NEX Program and details, as well, the exemption criteria already addressed. It should be consulted for more detailed information.

9. Distribution of Profits

The NEX program is also unique in the manner in which it distributes its profits. Utilizing the analogy of the NEX customer as a shareholder in the organization, there are three distinct points to be made.

First, with the exception of profits retained for reinvestment in the NEX program, all profits generated by the

exchanges are distributed indirectly to its shareholders through morale, welfare, and recreation programs.

Second, though a portion of the profits are not distributed but are instead retained for reinvestment in the program, the ultimate beneficiary remains the shareholder.

The third point which makes the policy unique is in the timing of profit distribution. Unlike most private enterprises which normally distribute dividends at the end of the year, or, perhaps, the end of the quarter, the NEX shareholders receive their benefits monthly.

There are additional comments to be made on profit generation and distribution in the NEX Program. These, however, will be addressed in the discussion of financing the Navy Exchange Program.

III. THE ANALYSIS

A. METHODOLOGY OF ANALYSIS

The analysis presented herein is an in-depth financial review of the Navy Exchange Program commencing in fiscal year 1973. It spans the six year period up to and including fiscal year 1978. The review includes the examination of various aspects of the financial condition of the program as well as the results of its operations over this six year period.

The analysis sections are prefaced with a brief overview of the financing of the Navy Exchange Program. This preface is not intended to present the operational accounting in detail, but moreover, to present some of the major characteristics of the accounting system. This will enable even those unfamiliar with the exchange operation to better comprehend the format and structure of the financial statements addressed in this chapter.

Immediately following the preface is a complete presentation of the data to be utilized in the analysis. It includes the consolidated financial statements of the NEX Program for the six fiscal years being examined. The data is presented in a technique known as comparative financial statements.

Comparative financial statements involve a presentation of balance sheets, income statements, and statements of changes in financial position for two or more years in side

by side fashion to enhance the review of changes which have occurred in individual categories therein from year to year or over a span of multiple years. The most important factor revealed by comparative financial statements is trend. The comparison of statements over a number of years, such as the six to be analyzed herein, also reveals the direction, velocity and the amplitude of the trend. As the purpose of the research is to analyze the trends of the financial performance of the NEX Program, presentation in this format is most useful in employing the data in other analytical techniques.

Amplifying the comparative financial statements in the data will be a summary of the notes to the financial statements. Besides defining specific accounting policies utilized by the NEX Program, the notes also provide timely remarks concerning changes in accounting policies or changes in organizational structure which impact the financial posture.

After the data is presented, the ensuing section employs the data in various techniques to provide analytical substantiation for the discussion which follows. One technique to be utilized will be the recasting of the comparative financial statements into an index-number trend series.[48] This method entails identifying a base year, fiscal 1973 in this case, and assigning all line items on the income statement or balance sheet for this year with an index of one hundred. The index for each year subsequent to the base year is then computed utilizing the ratio of that year's figures for a

given line item to the base year's figure for the same item, multiplied by one hundred. This technique provides a more visible, easily decipherable presentation of trend. In the statements recast by this method, only the items selected and deemed most significant by the author have been included.

The most expansive portion of the numerical analysis involves the computation of the financial or business ratios for the NEX operation. These ratios are simply a means of highlighting in arithmetical terms, the relationships between figures drawn from the financial statements. The analysis of a ratio can disclose relationships as well as bases of comparison which reveal conditions and trends that cannot be detected by an inspection of the individual components of the ratio.

Each ratio utilized in the analysis will be identified by its components with one sample calculation provided. The same ratios will be computed for each of the six years under examination and a summary will be presented in tabular form. The trends of performance which become apparent from the ratio summaries will be an integral part of the analysis discussion.

As a final effort to provide an overall evaluation of the NEX Program as a financial entity in the retail environment, the ratios computed from the NEX financial statements will be compared to a variety of operating ratios of retail

department and discount stores in the civilian sector. This will provide the reader with some indication of the impact resulting from the aforementioned dissimilarities of the NEX and commercial enterprises, in both policy and operating procedures, as well as, a general comparative evaluation of its performance.

The concluding portion of this chapter provides a detailed discussion of the financial conditions and trends which have become apparent from the numerical analysis. The discussion will be presented in the following six general categories, referred to occasionally as the building blocks of financial analysis:[49]

(1) Short-term liquidity

(2) Funds flow

(3) Capital structure and long-term solvency

(4) Return on investment

(5) Asset utilization

(6) Operating performance

Short-term liquidity refers to the ability of an enterprise to meet its current obligations. Liquidity implies the ready ability to convert assets into cash or to obtain cash in the short-run. Lack of liquidity impacts the operation in varying degrees depending on its severity. Ultimately, however, if an enterprise cannot meet its current obligations as they become due, its continued existence becomes in doubt and other measures of performance become of secondary concern.

The analysis of funds flow involves identifying the movement of funds within and throughout an organization. Funds flow analysis allows the reconstruction of many important resource decisions made regarding operations, investments, and financing based upon financial statement information. It is a comparative process which identifies shifts in financial condition and the impact of operations. It structures these into a framework of funds "uses" or investing applications, and funds "sources" or financing provisions. The sorting out of the funds flow within this framework allows insight into and evaluation of both policy and management decisions.

Capital structure and long-term solvency concern the equity and debt relationships of an enterprise and how these relationships impact its ability to meet its liabilities on a continuing basis beyond the next operating cycle. The capital structure of an enterprise consists basically of its equity funds and debt. It is measured in terms of the relative magnitude of the various sources of funds of the enterprise. The inherent financial stability of an enterprise and the risk of insolvency to which it is exposed are importantly dependent on the sources of its funds as well as on the type of assets it holds and the relative magnitude of such asset categories.[50]

Return on investment (ROI) is one of the most widely recognized measures of enterprise performance. It relates

income to the amount of investment that was committed to earning the income. ROI plays a very important role in the individual investment decisions of an enterprise as well as in the planning, budgeting, coordination, evaluation, and control of business operations and results. Hence, ROI is considered by many to be a reasonable indicator of managerial effectiveness.[51]

Asset utilization involves the analysis of how effectively the various assets of an enterprise are employed in generating revenues. The intensity of this employment is usually measured by asset turnover ratios. Though various characteristics of an enterprise's policies and operations can be deciphered from asset turnover ratios, meaningful evaluation comes primarily from comparing the ratios to the respective industry's average ratios for the same operating period, from a trend analysis with the enterprise's ratios over a number of operating cycles, or with the stated numerical goals and standards of the enterprise.

Operating performance is, in simple terms, the measure of how well the enterprise performed during a specified period of time. The income statement presents in a summarized fashion the results of the operations of an enterprise. The measurement of performance, however, goes beyond the magnitude of the net income or "bottom line". It involves delving into the various aspects of the operation whose net result is the bottom line. Sales, cost of goods sold, labor expenses, administrative expenses, gross profit, and net income are just some of the line items considered.

The measurement of performance is accomplished through any one or all of a variety of techniques. Performance can be measured against a budget; actual performance compared to planned performance. It can be measured against some standard, such as an overall industry standard or the operating results of a close competitor. Performance can also be measured against an enterprise's own past performance. This evaluation should be measured not just by changes from one year to the next, but to be effective, should include trends in performance evidenced over a longer period of time. The operating performance evaluation of the NEX operations incorporates the later two of these methods.

By utilizing the tools and techniques presented and the six general categories, the author feels that the subsequent analysis will provide sufficient scope to thoroughly evaluate any financial aspect of the NEX operation. The sum result of the categorical discussions should provide an excellent broad picture of the financial condition and current trends of financial performance in the NEX program.

B. FINANCING THE NAVY EXCHANGE PROGRAM: AN OVERVIEW

The Navy Exchange Program is somewhat of a unique entity in the Department of the Navy because it is one of the few programs whose mission includes making a net profit in its operations. It is categorized as a non-appropriated fund activity, meaning that it is not supported through funds appropriated by Congress to the Department of the Navy for

carrying out the Navy's mission. It is basically a self-sufficient, self-sustaining program and, thus, requires rather different philosophies and techniques in management and operational control.

Divorcing itself from the traditional expense center management control philosophy most common in the non-profit sector of DOD, the Navy Exchange Program more fittingly adopts the revenue or profit center philosophy. The operation of the NEX Program as a non-appropriated fund activity is financed in much the same way as any large, multi-store retailing organization with two aforementioned major exceptions: (1) capital can not be raised by stock or bond issues, and (2) borrowing from commercial institutions for short-range cash requirements, such as inventory build-up in the Fall season, can only be utilized after all other sources within DOD have been solicited.[52]

As mentioned previously, with the exception of the establishment of a new base or the reconstruction of a facility destroyed by an "Act of God," NEX facilities have, for many years, been paid for by the exchange customer by channeling a percentage of NEX profits back into the program. Inventory investment and the cost of higher inventories are likewise financed through exchange profits as are other facilities improvement projects.

Generating sufficient profits to accomplish the capital improvement projects concurrent with fulfilling the other major aspect of the NEX mission, providing funds for support

of the Navy recreation program, does not occur by happenstance. It is a well orchestrated effort throughout the various echelons of management and has its genesis in the planning phase at NAVRESSO.

1. Planning

According to Mr. Roy Newhouse, Comptroller at NAVRESSO, the NEX annual financial plan is the major management tool that serves as the means of controlling the operation of the NEX program.[53] It is prepared by NAVRESSO and approved by the Commander, Naval Supply Systems Command (NAVSUP). Forecasts in the plan are based upon an evaluation of input from field activities and NAVRESSO's operating division combined with current trends in sales and profits, the anticipated rate of inflation and the number of authorized patrons. All of these factors are reviewed and analyzed to obtain a projected bottom line net program profit. The plan is prepared in considerable detail including monthly projections of system wide operating results and pro forma balance sheets.

The forecasted figures in the plan are not "locked in stone" during the year. The plan is revised as often as necessary, but at least once at mid-year. All NAVRESSO divisions as well as field activities provide, as appropriate, updated projections and all important assumptions are reevaluated and compared to the latest trends.

In addition to the annual plan, each Navy exchange prepares and submits a detailed monthly operating budget projection. The projections are reviewed quarterly and are

synchronized with the annual plan to serve as the short term performance target for each exchange.[54]

The actual operating performance of each exchange is compared monthly to its projected budget, and all significant unfavorable variances must be explained to NAVRESSO. The explanation also includes a brief description of any corrective action taken.

Aside from the monthly performance appraisals of the individual exchange operations, all aspects of the entire program are also reviewed and compared to the plan. A report, issued by the NAVRESSO Comptroller, comments on the month and year-to-date performance and provides an analysis of operations, central office and centrally funded expenses, balance sheet and financial ratios, inventory levels and source and use of funds.[55] Significant variations are explained and courses of action are recommended. An example of the comptroller's report is included as Appendix B.

To ensure financial viability over a longer timeframe, NAVRESSO also prepares annually a five year financial plan. This plan is somewhat less detailed, and evaluates the effect of contemplated actions over this expanded time horizon. It is particularly important in highlighting the financial aspects of the facilities construction and improvement plans where three to five years is a normal time span from the approval of a project to its completion.

The five year plan is coordinated with the Bureau of Naval Personnel (BUPERS) so that their advance planning recognizes the NEX program's profit outlook over the next five years. In establishing its plan NAVRESSO attempts to maintain a balance between the needs of the Navy exchanges and the requirements of the welfare and recreation programs so that the men and women of the Navy and their dependents will receive substantial benefits from both operations.

2. Revenues and Pricing

A major aspect of the planning phase involves the estimate of sales revenues to be generated by all NEX operations. The magnitude of this estimate depends heavily upon both the volume of merchandise and services sold as well as the prices charged, respectively.

The volume of sales generated by the exchanges is itself dependent upon a number of variables. Some of the most impacting factors in the recent past have been outside the sphere of NEX management. The reduction of military personnel, particularly in the Pacific Ocean areas, has already been addressed. Patron drawing power to NEX service stations has been reduced by the higher, less competitive gasoline prices resulting from Federal Energy Administration pricing regulations and substantially higher product costs.

Other factors impacting the total NEX sales picture include increasingly strong commercial competition in metropolitan areas; cigarette price increases coupled with reduced

per capita consumption (cigarette sales represent almost $90 million per year in NEXs); and the transfer of the Enlisted Clubs and Package Stores to the operational cognizance of the Chief of Naval Personnel over the fiscal years 1976 and 1977. Projecting the impact of these and other known factors affecting sales volume is difficult; not to mention the impact of other unknowns which occur during the year. All, of course, must be considered in conjunction with existing or proposed pricing policies for the program.

The pricing policy of the NEX Program is tied directly to its mission statement. The general pricing policy for retail stores is as follows:

> Retail prices are established in a manner to accomplish the mission of the exchange ... Normally, essential items will be priced to generate the lowest gross profit and less essential items will be priced to generate higher gross profit, resulting in an adequate total Retail Departments contributions to exchange profits.[56]

It is also the intent of the exchange program to attempt to provide all of its authorized patrons, like products at the same price.

> Prices are established wherever practicable on a "one price" basis to afford equal opportunity for all authorized patrons regardless of size or location of exchanges.[57]

This uniformity of pricing is accomplished primarily through the use of the NAVRESSO Bulletins.

> All merchandise listed on Navy Resale Systems Office Bulletins will be priced as indicated thereon.[58]

Since not all merchandise is procured through the use of NAVRESSO bulletins, NAVRESSO provides guidance to the

NEXs for the pricing of merchandise procured through other means. This guidance is published in the NAVRESSO Instruction 4265.11 series, Retail Departments Stocking and Pricing Instructions. This series of instructions provides the exchanges the appropriate percentage mark-ons to apply to the merchandise or, in some cases, pricing schedules which indicate the retail price to be utilized over various ranges of merchandise costs.

Prices utilized in service outlets are, for the most part, established by the local NEO. These charges are determined by considering employee time required to provide the service, costs of any materials consumed, miscellaneous overhead expenses, and the desired level of profit contribution from the outlet; specified for each service department in the NEX Manual. These margins also are designed such that an adequate contribution to exchange profits is provided by the service outlets. The magnitude of the entire programs' contribution is, of course, still dependent on the total sales revenue generated.

3. Expenses

The basic accounting equation used to compute the net profit of any operation is to determine the total sales revenue earned and subtract from it the various expenses incurred to arrive at that sales level. Having discussed revenues briefly, it is appropriate to continue with how the revenue is distributed. Exhibit III-1 portrays graphically how fiscal year 1978 revenues were utilized.

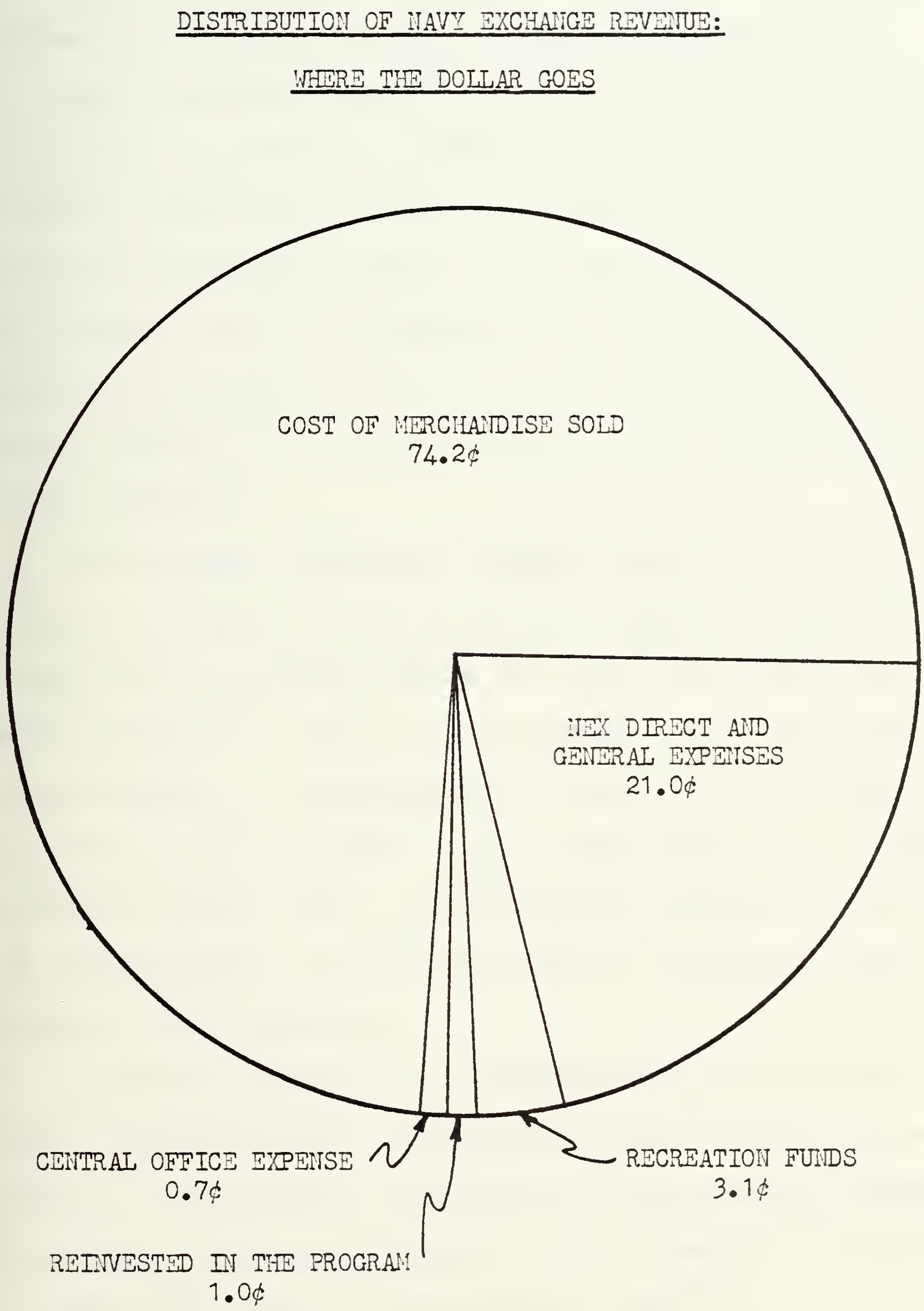


EXHIBIT III-1

The major portion of revenues is consumed by paying for the merchandise sold during the year. This expense is called cost of sales on the financial statements and includes the reserves applied to cover any inventory shortages.

Navy exchange direct expenses account for the next major portion of revenue consumption. These expenses include NEX payroll, employee benefits, supplies, utilities, repairs and minor replacement projects, and depreciation for equipment. (Note: Prior to February, 1977, depreciation for equipment was charged as a central office expense for exchanges, and was not charged directly against the individual exchange operation.)

NEX general expenses include a myriad of items. Payroll and employee benefits for the support functions of the operation; including warehouse, administrative, maintenance, personnel, and security; consume the major portion of this category. Depreciation for buildings, building improvements, and equipment are included here and are the next major expense area. Other exchange expenses, not able to be tied directly to specific areas of operation, are included in this category.

NAVRESSO expenses for exchanges represent those expenses incurred at the headquarters office which can be attached to the specific operation of the exchange program in the field. Exchanges are currently assessed nine-tenths of a percent of sales to cover these costs.[59]

NAVRESSO central office expenses are those expenses incurred at the headquarters office which are the result of fulfilling the basic support mission to the exchange program. Exchanges are currently assessed seven-tenths of a percent of sales to cover these costs.[60]

In aggregating all of the expenses into a consolidated income statement for the NEX program, NAVRESSO has chosen to draw common lines across the various expense categories mentioned above. Cost of sales; salaries, wages, and employee benefits; depreciation; and other; are the line descriptions utilized in the income statements presented in the data. A detailed operating statement for fiscal years 1977 and 1978 is included as Appendix C for a more in-depth view of the composition of the various categories of expenses and incomes.

4. <u>Inventory Management</u>

In the NEX Program, as in private sector worldwide retail enterprises, merchandise inventory is the largest asset on the balance sheet. Hence, inventory control is a critical factor in determining the availability of funds to purchase new merchandise, sustain daily operations and generate funds to support the recreation programs.

The NEX program utilizes an open-to-buy plan to control its inventories at the exchange level. Open-to-buy is simply a retail dollar figure of funds available for retail procurement for a specific month. It is calculated by comparing planned sales for a month with the necessary inventory at the beginning of the month and the amount of inventory

that will remain at the end of the month to support sales for the next month. Planned sales are computed for each department utilizing the stock-to-sales ratios provided by NAVRESSO. These ratios are the primary constituent of the inventory control mechanism for the NEX's.

NAVRESSO has an aggressive policy of followup whenever the actual inventory of an exchange or exchange complex significantly exceeds planned levels. Their policy is reinforced by the Retail Inventory Incentive Plan, a plan devised to keep inventory management an area of prime interest to NEOs. NAVRESSO assesses a penalty charge, based on current interest rates, whenever a Navy exchange exceeds its planned inventory by more than five percent for two successive months.[61] This charge goes against the local exchange as an additional cost of its operation and thus reduces its net income for the period.

NAVRESSO also emphasizes to its exchanges the need to avoid building inventories of overaged stocked. Commencing in 1975, NAVRESSO established a reserve to fund markdowns needed to dispose of overaged merchandise being held in inventories at that time. Exhibit III-2 is an excerpt from the comments provided to NAVRESSO in the audit report of the financial statements of fiscal year 1978. It briefly describes the program and the progress made since its implementation.

AUDITOR'S STATEMENT REGARDING THE NEX PROGRAM'S OVERAGED INVENTORY

At the end of fiscal 1975 Central office established a reserve of $1,000,000 to fund markdowns needed to dispose of overaged merchandise on hand as of that date. Charges to the reserve were made only in those situations where it was determined that the local exchange did not have sufficient profits to absorb the markdowns required to dispose of overaged merchandise. Normal markdowns were not charged to this reserve. At the end of fiscal 1976, 1977, and 1978, additional amounts of $700,000, $500,000, and $300,000, respectively was added to the markdown reserve. Under a program designed to dispose of overaged merchandise, approximately $900,000, $650,000 and $500,000 of the markdown reserve was utilized in 1976, 1977, and 1978, respectively, with the effect that merchandise over one year in age at the end of fiscal 1978 has decreased from the 1975 level as indicated in the following table:

	Over 1 Year		Inventory Reserve at Year End
1975	2.81	$3,193,280	$1,000,000
1976	2.17	2,692,280	700,000
1977	1.74	2,298,818	658,000
1978	1.53	2,200,000	450,000

Central office should continue to concentrate on reducing overage inventory amounts to eliminate requirements for future markdown reserves.

EXHIBIT III-2

5. Cash Management

Aside from its programs to effectively manage its tremendous physical inventories, NAVRESSO has also actively pursued effective management of its cash assets. As the program's average day's receipts in fiscal year 1978 was approximately $4.5 million,[62] the management of cash on a daily basis is essential.

NAVRESSO currently conducts a daily review of its fund status to determine what, if any, short, intermediate, or long-term investments should be made to maximize the use of its cash. It utilizes a combination of insured and collateralized investments; certificates of deposit and repurchase agreements for example; as the vehicles for its interest income. As mentioned in the discussion regarding investment income, NAVRESSO earned nearly three million dollars in 1978.

A major part of the cash management program revolves around the accounts payable portion of the operation. Insuring that all available discounts are taken is one of the primary objectives in cash management. In an operation the size of the NEX program, discounts amount to millions of dollars per year. In 1978, NEX purchase discounts amounted to $8.4 million.[63]

The corollary to taking advantage of all purchase discounts is that all invoices and contracts offering discounts must be paid within the discount period. In the past this meant paying these invoices as soon as possible to insure

no discounts were missed. This philosophy has been modified somewhat. Efforts are directed now so that invoices are tracked such that the payments go out on time to earn the discount, but no sooner than is necessary to qualify for it. Meanwhile, the cash, which eventually pays the invoice, remains in an interest earning investment. This same philosophy applies to accounts not offering discounts.

The management of cash inflows, primarily daily cash receipts from operations, is part of the daily cash review conducted by the office of Banking and Investment at NAVRESSO. Utilizing three major national banks to handle all NEX cash inflow and outflow transactions, the Banking and Investment Administrator reviews daily the cash changes in each bank. The review entails gathering the total cash deposited from the previous days receipts and the disbursements made by the payables section of the comptroller department. By applying an appropriate amount of float time, the time it takes for funds to actually be drawn out of the NEX accounts after checks have been issued for payment; and considering additionally the minimum cash balance required in each bank account and the short-term investments currently outstanding; the Banking and Investment Administrator determines what funds, if any, are available for investment that day. If funds are available the decision of where to invest is based upon the interest rates received on the aforementioned earning vehicles through offerings and solicitations and the professional judgment of the administrator.

6. Investments in Fixed Assets

NAVRESSO considers major investments in fixed assets through a long range plan. Supplemental to the long range plan is the annual project budget for the NEX Program.

The NEX project budget is developed by NAVRESSO's Facilities Division from input received from the exchanges as well as headquarters developed and proposed programs and projects. It is broken down into four basic categories; minor projects ($5,000 to $10,000), major projects (alterations and new construction projects in excess of $10,000), repairs, and emergencies. The category of major projects is broken down further into two investment categories; profit producing and non-profit.

Profit producing investments are those which are designed to generate revenues in excess of the costs involved in the investment. New retail stores, modernization of existing stores, and the construction of new service outlets would be examples of this category.

Non-profit investments are those whose return is more or less intangible. Improved safety and security systems are examples of non-profit projects. Replacing worn or damaged equipment, or installing employee or customer convenience items also fall into this category.

In considering the annual project budget, NAVRESSO has established an aggregate minimum return on investment (ROI) for the entire NEX program of fifteen to twenty percent.[64] An aggregate ROI is utilized because of the scope of the NEX

mission. Though it may not be profitable to provide minimum service levels at some remote location, the NEX services may in fact be the only facilities available to the personnel stationed at the activity. The NEX mission is to provide service to all authorized patrons, particularly those without any other sources of support. Specifying a minimum ROI for each project would not be in consonance with the exchange mission.

Minor projects are included in the annual project budget, however, they are not included in the computation of the aggregate ROI for the budget. Repairs and the contingency for emergencies are also excluded from investment considerations, with the exception of the basic criteria of continuing need for the facility or equipment to provide the desired service levels.

Funds utilized for investment in fixed assets are obtained from within the NEX organization. The line item description in the financial statements which relates to these funds is "reinvested earnings."

7. Distribution of Profits

This topic has been previously addressed in the section regarding dissimilarities of NEXs and private enterprises. The significant factor from the financial standpoint is that all profits are either distributed or reinvested in the program for capital improvements.

Exchange profits are distributed based upon the individual operating statement of each exchange. Exhibit III-3

DISTRIBUTION OF EXCHANGE NET PROFIT
NRSO/166 (Rev. 8/76)

3ND-PPSO-10611

NAVY EXCHANGE AT	EXCHANGE NO.	DATE PREPARED
WORLDWIDE CONSOLIDATION		

	ITEM	CURRENT MONTH			FISCAL YEAR TO DATE		
1.	EXCHANGE NET PROFIT (PER AUDITED STATEMENT) FOR MONTH OF: JANUARY 1979	* 2,887	078	87	43,359	715	46
2.	LESS: *LOSS(ES) FOR MONTH(S) OF: Fiscal Year 1977		-0-		93	053	89
	Fiscal Year 1978	2	073	39	1,002	643	88
3.	LESS: ~~[illegible]~~ AMUSEMENT VENDING (M3)	17	745	00	143	336	00
4.	LESS: MAIL ORDER PROFIT RETAINED (260-010)	11	560	00	475	167	23
5.	LESS: MEAT PROCESSING (K-7) (050 991 & 120-027)		366	56	(61	360	68)
		3	925	33	(66	752	98)
6.	PLUS: RETAIL CLOTHING STORE (L-1) OPERATING COSTS	(91	162	36)	(1,694	963	47)
		(90	556	10)	(1,694	963	47)
7.	TOTAL DEDUCTIONS (2 THRU 6)	(55	252	38)	(47	520	45)
8.	EXCHANGE PROFITS AVAILABLE FOR DISTRIBUTION (LINE 1 LESS LINE 7)	2,942	331	25	44,409	880	79
9.	LESS: REINVESTED IN PROGRAM %	708	133	10	10,225	516	66
10.	LESS: BA SNACK BAR (K4)	15	742	00	236	567	00
11.	LESS: BA AMUSEMENT VENDING (M3)		-0-		38	239	00
12.	LESS:		-0-			-0-	
13.	LESS:		-0-			-0-	
14.	TOTAL OTHER DEDUCTIONS (8 THRU 13)	723	875	10	10,500	322	66
15.	EXCHANGE PROFIT AVAILABLE FOR DISTRIBUTION TO RECREATION FUNDS (LINE 8 LESS LINE 14)	2,218	456	15	33,909	558	13
16.	LESS: % OF LINE 15 FOR CHIEF OF NAVAL PERSONNEL	1,205	218	43	17,505	539	02
17.	BALANCE AVAILABLE FOR STATION LOCAL RECREATION FUND (LINE 15 MINUS LINE 16)	1,013	237	72	16,403	969	11
18.	LESS: **INVENTORY SHORTAGE IN EXCESS OF PROVISION AS AT: Jan 78	4	279	03	345	101	87
19.	PLUS: BA SNACK BAR (K4)	(15	742	00)	(236	567	00)
20.	PLUS: BA AMUSEMENT VENDING (M3)		-0-		(38	239	00)
	PLUS: AMUSEMENT VENDING (M3)	(17	745	00)	(143	336	00)
21.	DISTRIBUTION TO STATION LOCAL RECREATION FUND CREDITED TO BUPERS RECREATION FUND CONCENTRATION ACCOUNT (LINE 17 MINUS LINE 18 THRU 20)	1,042	445	69	16,477	009	24

*Difference of $3,059.82 Current only between Worldwide Operating Statement and Line 1 due to adjustment for 270-100 effected subsequent to completing of Consolidated Operating Statements.

	UNDEPRECIATED BALANCE PER AUTHORIZED			EXPENDED		
22. A/C 137 - 181 BUILDING IMPROVEMENTS	13,329	703	92	7,368	734	35
23. A/C 147 - 182 BUILDINGS	52,816	744	02	14,594	559	30
24. A/C 148 - 183 - 184 BUILDINGS AND BUILDING IMPROVEMENTS		-0-			-0-	

*UNAPPLIED LOSSES		**INVENTORY SHORTAGE BALANCE DUE	
	F/Y 77 -0-		F/Y 77 -0-
	F/Y 78 $1,686,374.78		F/Y 78 $246,185.35

EXHIBIT III-3

displays the form utilized for profit distribution. The sample provided is for the entire NEX system for fiscal 1978. Were it an individual exchange statement, it would have a percentage assigned in the appropriate block on line nine. This percentage for reinvestment is based upon the size of the respective operation. Line sixteen also has a percentage assigned, however it is the same for all exchanges, fifty percent.

A summary of total NEX profit distribution since 1973 is presented in Exhibit III-4. This exhibit also presents the distribution of profits in somewhat of a "dividend" format; that is dollars of recreation funds generated per active duty Navy person. The trends exhibited in this table will be discussed in more detail in subsequent sections of this chapter.

C. DATA PRESENTATION

The following data has been consolidated from NAVRESSO's detailed financial and operating statements for the Navy Exchange Program from fiscal year 1973 through fiscal year 1978. For presentation, the author has structured the format of the statements similar to those published by NAVRESSO in their report, <u>A Review: Navy Resale Systems Operations 1977</u>.[65] Due to some differences in the selection of individual line items and how these items were grouped for presentation, the figures the author has utilized may vary somewhat from those which were computed by NAVRESSO. These differences are

NET PROGRAM PROFIT REINVESTED AND DISTRIBUTED
1973 - 1978

	1973	1974	1975	1976	1977	1978
Net Program Profit ($1,000)	55877	53365	46752	45922	41809	46250
Distribution:						
Local Recreation Funds	24970	24869	22459	20754	19534	18532
Central Recreation Fund	13225	14098	12822	16476	18389	17506
Subtotal	38195	38967	35281	37230	37923	36038
Enlisted Clubs Entertainment and Refurbishment	3854	3792	3945	3623	1104	-0-
Navy lodges	697	-0-	-0-	-0-	-0-	-0-
Mail Order Profits	374	326	379	394	991	408
Subtotal	43120	43085	39605	41247	40018	36446
Reinvested in NEX Program	12757	10280	7147	4675	1791	9804
Net Program Profit:	55877	53365	46752	45922	41809	46250
Recreation Funds Contributed Per Active Duty Navy Person:	$68	$71	$66	$71	$72	$68

EXHIBIT III-4

considered by the author to be of little significance to the overall results of the analysis conducted.

The sequence of data presentation is intended to resemble the traditional format of financial statement publication, which begins with a comparative balance sheet covering the six year period of study. Immediately following the comparative balance sheet is the comparative statement of income and reinvested earnings. This is a consolidated statement presenting the major financial groupings normally represented in a statement of income in the private sector, i.e., revenues, expenses, net income, and distribution of equity.

Following these two comparative financial statements is the comparative statement of changes in financial position. The statement is presented in two parts. The first analyzes all of the sources and uses of working capital and derives the change in working capital. The second portion of the statement provides a detailed analysis of the changes in current assets and liabilities which substantiates the change in working capital.

Because of various accounting changes which occurred over the six year period of evaluation, it was, with the information available to the author, virtually impossible to recast all of the statements in a single format. Hence, some years are presented twice using slightly different formats. These variances in presentation are considered by the author to be of insignificance to the overall results of the analysis.

Following all of the financial statements, which have been presented as Exhibits III-5 through III-8, is a consolidation of the notes to the financial statements, Exhibit III-9. In an attempt to avoid a voluminous section of information, those notes which were unaltered throughout the six year period have been presented only once. Notes reflecting changes to accounting policies have been included in their respective position within the particular year's financial statement notes, with the appropriate year identified. Upon completion of the data presentation, the author will commence with the quantitative analysis of the data.

D. ANALYSIS

1. Index-number Trend Series

The first portion of this section is dedicated to recasting both the comparative balance sheet and the statement of income and reinvested earnings into an index-number series of statements. As previously indicated, fiscal year 1973 will be utilized as the base year.

The recasting of the statements into index numbers is a relatively straight forward operation. A few sample calculations are provided so that the index numbers on the recast statements are meaningful.

Example 1: From the balance sheet, the 1973 accounts receivable figure of $8,810,000 is given the index of one hundred. Therefore, the 1974 accounts receivable figure of $11,268,000 becomes 127.9:

COMPARATIVE BALANCE SHEETS
($1,000's)

ASSETS	1978	1977	1976	1975	1974	1973
Current Assets:						
Cash & Cash Equivalents	18076	18806	17191	16893	5318	26940
Short-Term Investments	30817	22315	24455	23907	10544	11590
Accounts Receivable	19730	13729	10662	10143	11268	8810
Inventories (Net)	155801	145765	138138	131128	150298	135458
Prepaid Exp. & Other Current Assets	4544	4293	3187	3247	2634	2041
Total Current Assets	228968	204908	193633	185318	180062	184839
Marketable Securities for:						
Local/Natl Retire./Term.	7268	6379	6271	5915	6149	6843
Self-Insurance	5000	4590	4590	4590	5557	5353
Total Market. Securities	12268	10969	10861	10505	11706	12196
Fixed Assets @ Cost:						
Equipment	95646	94033	96293	95724	90556	
Buildings	39208	34764	31758	26998	19135	
Building Improvements	15721	12515	15573	19134	14988	
Total Fixed Assets	150575	141312	143624	141856	124679	88736
Less Accum. Deprec.	100710	94213	93901	90068	80792	58237
Net Fixed Assets	49865	47099	49723	51788	43887	30499
Other Assets:	4539	5298	3420	703	641	386
Total Assets:	295640	268274	257637	248314	236296	238697
LIABILITIES						
Current Liabilities:						
Accounts Payable	71744	59906	48670	45177	42607	50246
Accrued Salaries, Wages, & Benefits	13937	13311	13282	13845	12892	9709
Undistributed Profits	2690	1982	2081	2113	620	3064
Other Current Liabilities	13565	10157	10962	8619	7544	12597
Total Current Liabilities	101936	85356	74995	69754	63663	75616
Funded Reserve for Local/ Natl Retire. & Term.	7268	6379	6271	5915	6149	6843
Net Worth:						
Appropriated for:						
Contingencies		1900	1900	1900	1900	1900
Capital Improvements		8500	8500	8500	8500	8000
Revaluation of Invent.		500	500	500	500	500
Replace Govt Owned Equip.		375	375	375	375	375
Employee Death Benefits		24	24	24	24	24
Self-Insurance	5000	4590	4590	4590	5557	5353
Unappropriated:						
Net Worth Acquired	19951	19951	19951	19951	19951	19951
Reinvested Earnings	161485	140699	140531	136805	129677	120125
Total Net Worth	186436	176539	176371	172645	166484	156238
Total Liab. & Net Worth	295640	268274	257637	248314	236296	238697

EXHIBIT III-5

COMPARABLE STATEMENTS OF INCOME,REINVESTED EARNINGS
($1,000's)

	1978	1977	1976	1975	1974	1973
Net Sales	1135785	1073002	1051098	1047685	1026470	977403
Cost of Sales	849676	803202	775934	772817	759451	726472
Gross Profit	286110	269800	275164	274868	267019	250935
Selling & General Admin. Expenses:						
Salaries, Wages, & Emp. Benefits	199760	187612	188013	184379	175283	162560
Other	44649	42610	39775	39509	34988	29566
Depreciation	12762	13456	14676	15719	16525	15961
Total Expenses	257171	243846	242464	239607	226796	208087
Operating Income	28939	25953	32700	35261	40223	42844
Other Income:						
Purchase Discounts	8366	8344	7802	7094	7770	7678
Interest Income	2964	1899	2479	2118	2935	2684
Misc. Other Income	4287	4202	2688	2279	2438	2671
RCS Reimbursement	1695	1511	253	-0-	-0-	-0-
Total Other Income	17312	15856	13222	11491	13143	13033
NET INCOME	46251	41810	45922	46752	53366	55877
Reinvested Earnings at Beginning of Year	140699	140531	136805	129677	120135	107758
Subtotal	186950	182341	182727	176429	173501	163635
Less:						
Divestiture of EM Clubs	-0-	1624	948	18	239	379
Distributable Income:						
Local Rec. Funds	18532	19534	20754	22459	24869	24970
Bupers Cent. Rec. Fund	17506	18389	16477	12823	14098	13225
EM Club Refurb/Enter.	-0-	1104	3623	3945	3793	3855
Mail Order/Food Process.	408	991	394	379	327	374
Lodges	-0-	-0-	-0-	-0-	-0-	697
Other adjustments	-0-	-0-	-0-	-0-	498	-0-
Subtotal	36446	41642	42196	39624	43824	43500
Add:						
Return of Previously Appropriated for Funds	10982	-0-	-0-	-0-	-0-	-0-
Reinvested Earnings at End of Year	161485	140699	140531	136805	129677	120135

EXHIBIT III-6

STATEMENT OF CHANGES IN FINANCIAL POSITION

Sources and Uses of Working Capital
($1000's)

	1978	1977	1977	1976	1976	1975	1975	1974	1973
WORKING CAPITAL									
SOURCES:									
Net Income	46250	41810	41810	45922	45922	46751	47207	53366	NOT AVAILABLE
Depreciation	12762	13456	13456	14675	14675	15719	15719	16525	
Funds from Operations	59012	55266	55266	60597	60597	62470	62926	69891	
Decrease in Other Assets	15	554	-0-	-0-	-0-	-0-	-0-	-0-	
Decrease in Dues from Navy Prog.	744	-0-	-0-	-0-	-0-	-0-	-0-	-0-	
Increase in Funded Reserve for Local/Natl Retire & Term	889	108	-0-	-0-	-0-	-0-	-0-	-0-	
Divestiture of EM Clubs' Fixed Assets & Improvements	-0-	2030	2030	2773	2773	135	3	148	
Reclass. of Marketable Secs. formerly Set aside for self-insurance	-0-	-0-	-0-	-0-	-0-	967	-0-	-0-	
Subtotal	60660	57958	57296	63370	63370	73572	72929	70039	
USES:									
Distributable Income	36353	40018	40018	41248	41248	39605	39605	43085	
Increase in Equipment	7799	7037	7037	6417	6417	11614	11614	11614	
Increase in Bldgs/Bldg Improve.	7729	5825	5825	8966	8966	12141	12009	12139	
Divestiture of EM Clubs	-0-	1624	1624	948	948	18	18	239	
Increase in Dues from Navy Prog.	-0-	2432	2432	2352	-0-	-0-	-0-	-0-	
Increase in Marketable Secs. to Fund Reserve for Local/Natl.	1299	108	-0-	-0-	-0-	-0-	-0-	-0-	
Increase in Other Assets	-0-	-0-	654	365	566	62	62	255	
Reclass. of Self-Insurance to Other Current Liabilities	-0-	-0-	-0-	-0-	-0-	967	-0-	-0-	
Subtotal	53180	57044	57590	60296	58145	74407	73308	66882	
INCREASE/DECREASE in Working Capital	7480	914	(294)	3074	5225	(835)	(379)	3157	

EXHIBIT III-7

STATEMENT OF CHANGES IN FINANCIAL POSITION

Analysis of Changes in Working Capital
($1000's)

	1978	1977	1977	1976	1976	1975	1975	1974	1973
INCREASE/DECREASE in Current Assets:									
Cash & Cash Equivalents	(730)	1615	1615	298	298	11575	11575	(21622)	NOT AVAILABLE
Short-Term Investments	8502	(2140)	(2140)	548	548	13363	11952	(1046)	
Trade Accts & Receiveables	5426	3067	3028	519	2670	(1125)	(1125)	2458	
Merchandise Inventory	10036	7627	7201	7010	7010	(19170)	(19170)	14840	
Due from Navy Programs	575	-0-	-0-	-0-	-0-	-0-	-0-	-0-	
Prepaid Exp. & Other Current Assets	251	1106	96	(60)	(60)	613	613	593	
Subtotal	24060	11275	9800	8315	10466	5256	3845	4777	
INCREASE/DECREASE in Current Liabilities:									
Accounts Payable	11905	11260	11260	3555	3555	2570	2570	(7639)	
Accrued Salaries, Wages, & Emp. Benefits	627	29	29	(563)	(563)	953	249	4218	
Unremitted Distr. of Earnings	642	(1777)	(1777)	204	204	1405	1405	(4513)	
Other Current Liabilities	3406	849	582	2045	2045	1163	-0-	-0-	
Subtotal	16580	10361	10094	5241	5241	6091	4224	(7934)	
INCREASE/DECREASE in Working Capital	7480	914	(294)	3074	5225	(835)	(379)	3157	

EXHIBIT III-8

SUMMARY OF NOTES TO FINANCIAL STATEMENTS

(1) Summary of Accounting Policies

General

The Navy resale System Office (Navy Exchange Program) is established as an activity of the Navy and operates in an active status under the command and support of the Naval Supply Systems Command. The dominant portion of the Navy Exchange Program's operations consists of selling merchandise and services to military personnel and their families. The financial statements of the Navy Resale System Office include the operations of all exchanges at Navy bases and the operation of Enlisted Clubs through September 1977. The Navy Exchange Program is not subject to state and Federal income taxes.

The accounting policies employed by the Navy Exchange Program are consistent with generally accepted accounting principles. In those instances in which more than one generally accepted accounting principle can be applied, the Navy Exchange Program has adopted the accounting principle that it believes most accurately and fairly reflects the situation.

(a) Definition of Fiscal Year

The Navy Exchange Program's fiscal year consists of a 12-month period ending in the latter half of January.

Fiscal Year	Date Ended
1978	January 21, 1979
1977	January 22, 1978
1976	January 22, 1977
1975	January 25, 1976
1974	January 25, 1975
1973	January 26, 1974

Exhibit III-9

(b) Inventories

Merchandise inventories are valued at the lower of cost (first-in, first-out) or market, determined principally by the retail method.

(c) Pension Plan

The cost of pension plan benefits has been determined by the entry age normal method. Unfunded prior service costs are amortized over 30 years.

(d) Foreign Exchange Transactions

Transactions in foreign currency consist primarily of salaries paid to local nationals and payment for certain merchandise and supplies purchased from foreign vendors. Foreign exchange gains or losses on such transactions, which were not material, are credited or charged to income as incurred.

(e) Reserves Funded for Local National Employees' Retirement Termination Benefits

Status of Forces Agreements with certain foreign countries require that upon termination of employment, certain benefits must be paid to local nationals employed by exchanges in those countries. The amount of such benefits earned annually by these employees is charged to operations and funded by the Navy Exchange Program.

(f) Self-insurance

The Navy Exchange Program self-insures for routine business risks such as fire, burglary, workmen's compensation, employee fidelity transportation losses and employee medical expenses. Only losses actually incurred are charged against operations each year. Net assets has been appropriated and funded by marketable securities to cover any unusual losses which might occur which are in excess of insurance coverage.

Change in Accounting -Self-Insurance-FY 1976 Statement

The Navy Exchange Program self-insured for routine business risks such as fire, burglary, workmen's compensation, employee fidelity and transportation losses. To comply with the requirements of the Financial Accounting Standards Board Statement No. 5 - Accounting for Contingencies,

the Navy Exchange Program changed its method of accounting for self insured business risks and commenced providing for these risks as they are incurred rather than maintaining a general reserve. This change had the effect of decreasing 1976 net income by approximately $253,000. Financial statements for 1975 have been restated to reflect this accounting change and, accordingly, 1975's income decreased $456,000, and 1975's reinvested earnings increased $4,590,000, which represents the portion of the general reserve not allocated to specific claims incurred as of January 26, 1975. The increase in reinvested earnings has been appropriated and funded by marketable securities to cover any unusual losses which might occur which are in excess of insurance coverage.

(2) Facilities and Services

Under governmental regulations, various facilities and certain services are provided to the Navy Eschange Program without charge and, accordingly, their costs are not reflected in the financial statements.

(3) Fixed Assets

Equipment is depreciated by accelerated methods over the useful lives ranging from four to seventeen years.

In lieu of depreciating projects authorized prior to January 26, 1975 over estimated useful lives, the Navy Exchange Program provides for such costs by charges to operations over periods of five and ten years commencing with project authorization dates. If these capital improvements and building alterations were amortized over their estimated useful lives commencing with the project completion dates, the effect on net income would not be material.

Projects authorized subsequent to January 26, 1975 are being depreciated under the straight-line method over the following estimated useful lives.

	Buildings	Building Improvements
Continental U. S.	20 years	10 years
Overseas	10 years	5 years

(4) Pension Plan

All U. S. citizens, foreign nationals working in the United States, and citizens of Canada or Panama employed in those countries may participate in a contributory pension plan. Under the terms of the plan the Navy Exchange Program provided funds as follows for pension expense.

Fiscal Year	Funds Provided
1978	$11,055,000
1977	10,472,000
1976	10,339,000
1975	7,941,000
1974	6,068,000
1973	not available

(5) Divestiture of Enlisted Clubs - FY 78 Statement

In 1961, the Navy Exchange Program (Progam) was directed to assume responsibilities for the operations of Enlisted Clubs (Clubs) and the operations of the Clubs were consolidated into the Program. The Clubs' net profits were retained separately as a reserve for entertainment and refurbishment and the Clubs were charged a monthly assessment by the Program to defray central office costs of administration and financial support. In 1976, the Program was directed to transfer to the Bureau of Naval Personnel (BUPERS) operating control of the Clubs. Such transfer was completed in September 1977.

To effect these transfers, funds held by the Program in the reserve for entertainment and refurbishment for the remaining 75 Clubs transferred in fiscal 1977 aggregating $921,000, were paid to BUPERS; advances from the Program for capital improvements and renovation of the Clubs transferred in prior years totaling $3,401,000 will be repaid to the Program by BUPERS in amounts up to $500,000 annually commencing in 1979; merchandise inventory and net fixed assets of the Clubs transferred in fiscal 1977 aggregating $1,624,000 were transferred to BUPERS in settlement of accumualted Clubs' assessments in excess of central office costs which have been included in the Program's reinvested earnings.

Divestiture of Enlisted Clubs - FY 77 Statement

In 1961, the Navy Exchange Program (Program) was directed to assume responsibilities for the operations of Enlisted Clubs (Clubs) and the operations of the Clubs were

consolidated into the Program. The Clubs' net profits were retained separately as a reserve for entertainment and refurbishment and the Clubs were charged a monthly assessment by the Program to defray central office costs of administration and financial support. In 1976, the Program was directed to transfer to the Bureau of Naval Personnel (BUPERS) operating control of the Clubs. Such transfer was completed in September 1977.

To effect these transfers, funds held by the program in the reserve for entertainment and refurbishment for the remaining 75 Clubs transferred in fiscal 1977 and the 40 Clubs transferred in fiscal 1976 aggregating $1,494,000 and $921,000, respectively, were paid to BUPERS; advances from the Program for capital improvements and renovation of the Clubs transferred in fiscal 1977 of $1,250,000 and 1976 of $2,151,000 will be repaid to the Program by BUPERS in amounts up to $500,000 annually commencing in 1979; merchandise inventory and net fixed assets of the Clubs transferred in fiscal 1977 and 1976 aggregating $1,624,000 and $948,000, respectively, were transferred to BUPERS in settlement of accumulated Clubs' assessments in excess of central office costs which have been included in the Program's reinvested earnings.

Divestiture of Enlisted Clubs - FY 76 Statement

In 1961, the Navy Exchange Program (Program) was directed to assume responsibilities for the operations of Enlisted Clubs (Clubs) and the operations of the Clubs were consolidated into the Program. The Club's net profits are retained separately as a reserve for entertainment and refurbishment and the Clubs are charged a monthly assessment by the Program to defray central office costs of administration and financial support. In 1973, the Program was directed to transfer to the Bureau of Naval Personnel (BUPERS) operating control of certain Clubs. During 1976, this directive was amended to require the Program to transfer all remaining Clubs to BUPERS by October 1977.

To effect these transfers, funds held by the Program in the reserve for entertainment and refurbishment for the 40 clubs transferred in fiscal 1976 and the three clubs transferred in fiscal 1975 aggregating $921,000 and $52,000, respectively, were paid to BUPERS; advances from the Program for capital improvements and renovation of the clubs transferred in fiscal 1976 and 1975 aggregating $2,151,000 and $132,000, respectively, were or will be repaid to the Program by BUPERS; merchandise inventory and net fixed assets of the clubs transferred in fiscal 1976 and 1975 aggregating $948,000 and $18,000,

respectively, were transferred to BUPERS in settlement of accumulated Clubs' assessments in excess of central office costs which have been included in the Program's reinvested earnings.

As of January 22, 1977, the Program retains operational control of 76 Clubs, which will be transferred during fiscal 1977. Such transfers will not have a material effect on financial position or results of operations of this Program.

Divestiture of Certain EM Clubs - FY 75 Statement

In 1961, the Navy Exchange Program (Program) was directed to assume responsibilities for the operations of Enlisted Men's Clubs (EM Clubs) and the operations of the EM Clubs were consolidated into the program. EM Clubs' net profits are retained separately as a reserve for entertainment and refurbishment and EM Clubs are charged a monthly assessment by the Program to defray central office costs of administration and financial support. In 1973, the Program was directed to transfer to the Bureau of Naval Personnel (BUPERS) operating control of certain EM Clubs. As of January 25, 1976, thirty-one EM Clubs were transferred to BUPERS.

To effect these transfers, funds held by the Program in the reserve for entertainment and refurbishment for the three clubs transferred in fiscal 1975 and the eleven clubs transferred in fiscal 1974 aggregating $52,000 and $405,000, respectively, were paid to BUPERS; advances from the Program for capital improvements and renovation of the clubs transferred in fiscal 1975 and 1974 aggregating $132,000 and $9,000, respectively, were repaid to the Program by BUPERS; merchandise inventory and net fixed assets of the clubs transferred in fiscal 1975 and 1974 aggregating $18,000 and $239,000, respectively, were transferred to BUPERS in settlement of accumulated EM Clubs' assessments in excess of central office costs which have been included in the Program's reinvested earnings.

As of January 25, 1976, the Program retains operational control of 127 EM Clubs. No decision has been made regarding the transfer of these remaining EM Clubs.

$$\frac{11,268,000}{8,810,000} \times 100 = 127.9$$

Example 2: From the balance sheet, utilizing the accounts receivable once again, the 1975 figure of $10,143,000 becomes 115.1:

$$\frac{10,143,000}{8,810,000} \times 100 = 115.1$$

It should be noted that when using index numbers, percentage changes can not be read off the statements directly except by reference to the base year. Thus the change of accounts receivable from 1973 to 1974 is 27.9 percent (index 127.9 - index 100), and this can be read directly from the index numbers. The change from 1974 to 1975, however, is not 12.8 percent (127.9 - 115.1), as a direct comparison may suggest. The actual change is 9.98 (1,125/11,268) which involves computing the 1974 to 1975 change by reference to the amount at 1975. The percentage change can, however, be computed by use of the index numbers only for example: (127.9 - 115.1)/ (127.9) = 10.0 percent, the difference from 9.98 being from rounding in the calculation of the index numbers.

The index-number trend series financial statements are presented as Exhibits III-10 and III-11. This technique has not been utilized on the statement of changes in financial position because of the difficulties encountered with the various changes in accounting policy during the period being

INDEX NUMBER SERIES BALANCE SHEETS

1973 - 1978

	1978	1977	1976	1975	1974	1973
ASSETS:						
Current Assets:						
Cash and Equivalents	67.1	69.8	63.8	62.7	19.7	100.0
Short-Term Investments	265.9	192.5	211.0	206.3	91.0	100.0
Accounts Receivable	223.9	155.8	121.0	115.1	127.9	100.0
Inventories (Net)	115.0	107.6	102.0	96.8	111.0	100.0
Prepaid Expenses and Other Current Assets	222.6	210.3	156.1	159.1	129.1	100.0
Total Current Assets	123.9	110.9	104.8	100.3	97.4	100.0
Marketable Securities for Local/National Retirement & Termination	106.2	93.2	91.6	86.4	89.9	100.0
Self-Insurance	93.4	85.7	85.7	85.7	103.8	100.0
Subtotal	100.6	89.9	89.1	86.1	96.0	100.0
Total Fixed Assets	169.7	159.2	161.9	159.9	140.5	100.0
Less: Accum. Deprec.	172.9	161.8	161.2	154.7	138.7	100.0
Net Fixed Assets	163.5	154.4	163.0	169.8	143.9	100.0
Other Assets	40.7	47.5	30.6	6.3	5.7	100.0
Total Assets	123.9	112.4	107.9	104.0	99.0	100.0
LIABILITIES:						
Current Liabilities:						
Accounts Payable	142.8	119.2	96.9	89.9	84.8	100.0
Accrued Salaries, Wages, & Employee Benefits	143.5	137.1	136.8	142.6	132.8	100.0
Undistributed Profits	87.8	64.7	67.9	69.0	20.2	100.0
Other Current Liabilities	107.7	80.6	87.0	68.4	59.9	100.0
Total Current Liabilities	134.8	112.9	99.2	92.2	84.2	100.0
Funded Reserve for Local/ National Retire & Term.	106.2	93.2	91.6	86.4	89.9	100.0
Net Worth:						
Appropriated for:	30.9	98.4	98.4	98.4	104.4	100.0
Unappropriated:						
Net Worth Acquired	100.0	100.0	100.0	100.0	100.0	100.0
Reinvested Earnings	134.4	117.1	117.0	113.9	107.9	100.0
Subtotal	129.5	114.7	114.6	111.9	106.8	100.0
Total Net Worth	119.3	113.0	112.9	110.5	106.6	100.0
Total Liabilities & Net Worth	123.9	112.4	107.9	104.0	99.0	100.0

EXHIBIT III-10

INDEX-NUMBER SERIES STATEMENT OF INCOME

AND REINVESTED EARNINGS: 1973 - 1978

	1978	1977	1976	1975	1974	1973
Net Sales	116.2	109.8	107.5	107.2	105.0	100.0
Cost of Sales	116.9	110.6	106.8	106.4	104.5	100.0
Gross Profit	114.0	107.5	109.7	109.5	106.4	100.0
Salaries, Wages and Emp. Benefits	122.9	115.4	115.7	113.4	107.8	100.0
Total Expenses	123.6	117.2	116.5	115.1	109.0	100.0
Purchase Discounts	108.9	108.7	101.6	92.4	101.2	100.0
Interest Income	135.7	86.9	113.5	97.0	134.9	100.0
Total Other Income	132.8	121.7	101.5	88.2	100.8	100.0
NET INCOME	82.8	74.8	82.2	83.7	95.5	100.0
Distributable Income:						
Local Rec. Funds	74.2	78.2	83.1	89.9	99.6	100.0
BUPERS Rec. Fund	132.4	139.0	124.6	97.0	106.6	100.0
Refurb. & Entertain for EM Clubs	-0-	28.6	93.9	102.3	98.4	100.0
Mail Order/Food Proc.	109.1	264.9	105.3	101.3	87.4	100.0
Lodges	-0-	-0-	-0-	-0-	-0-	100.0
Subtotal	83.8	95.7	97.0	91.1	100.7	100.0
Reinvested Earnings for Current Year	76.9	14.0	36.6	56.0	80.6	100.0
Total Reinvested Earnings @ End of Year	134.4*	117.1	117.0	113.9	107.9	100.0

* Includes return of previously appropriated for funds

EXHIBIT III-11

researched. As a final offering in this technique, Exhibit III-12 graphically portrays the index numbers computed for sales, gross profit, and net income.

2. Ratio Analysis

A great many ratios can be developed from the multitude of items included in an enterprises's financial statements. Some ratios have general application in financial analysis, while others have specific uses in certain circumstances or in specific industries. Such is the scope of the ratios utilized herein. Many are considered as most applicable to any business situation. Others have been specifically identified as key business ratios for the retail industry as published by Dun and Bradstreet, Incorporated.

The ratios will be presented in groups corresponding to the general categories previously identified save funds flow analysis. This will augment the discussions which follow in subsequent sections.

a. Short-term Liquidity Ratios

(1) Current Ratio. The current ratio measures the relationship between current assets and current liabilities at a specific point in time. The mathematical relationship is as follows:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Example: For fiscal year 1973, the NEX current ratio equals (184,839) $\div$ (75,616) or 2.44.

THE RELATIONSHIP OF INDEX TREND NUMBERS
FOR NET SALES, GROSS PROFIT, AND NET INCOME

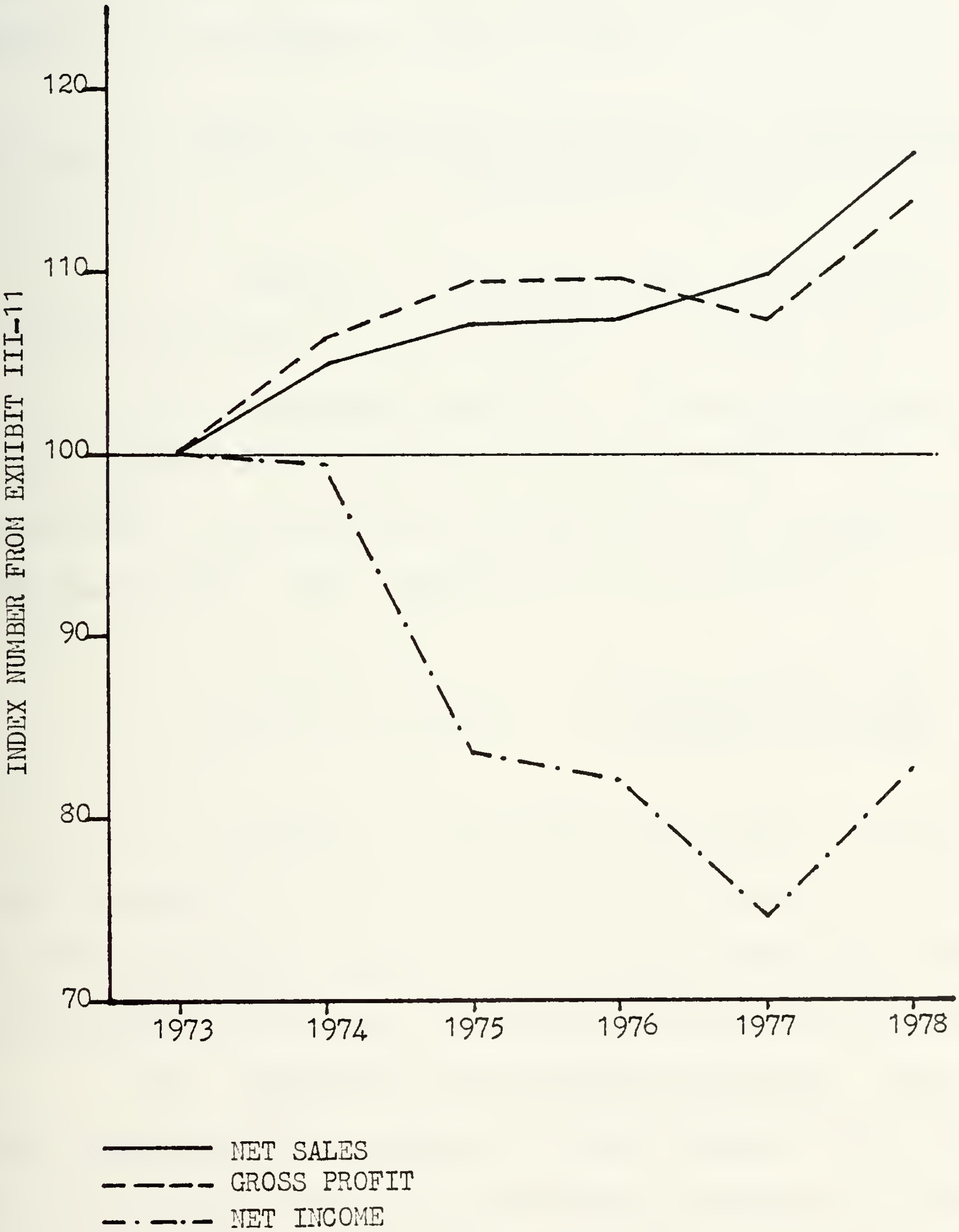


EXHIBIT III-12

(2) Acid Test. Also called the quick ratio, this ratio measures the relationship of those assets that are presumed to be readily convertible into cash at approximately their stated amounts to current liabilities. The mathematical relationship is as follows:

$$\text{Acid Test} = \frac{\text{Cash + Short-Term Investments + Receivables}}{\text{Current Liabilities}}$$

Example: For fiscal year 1973, the NEX acid test equals (26,940 + 11,590 + 8,810) ÷ (75,616) or 0.63.

(3) Inventory Turnover. Inventory turnover tends to measure the liquidity of the inventory. It is the relationship of the inventory to the volume of goods sold during the period. The computation is as follows:

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

Example: For fiscal year 1973, the NEX inventory equals (726,472) ÷ ((129,646 + 135,458) ÷ 2) or 5.48. The inventory figure of 129,646 was taken from the fiscal year 1972 statement of income and reinvested earnings.

(4) Inventory To Net Working Capital. Net working capital represents the excess of current assets over current liabilities. This ratio is an additional measure of inventory balance. Since the retail industry is inventory intensive, this ratio is higher than the eighty percent indicated as a normal upper limit by Dun and Bradstreet. It is as follows:

$$\text{Inventory To Working Capital} = \frac{\text{Merchandise Inventory}}{\text{Net Working Capital}}$$

Example: For fiscal year 1973, the NEX ratio is (135,458) ÷ (184,839 - 75,616) or 124 percent.

(5) Current Liabilities To Net Worth. This ratio is derived by dividing current liabilities by the net worth (tangible) of an enterprise. Dun and Bradstreet indicate that ordinarily a business begins to pile up trouble when this relationship exceeds eighty percent.

$$\text{Current Liabilities To Net Worth} = \frac{\text{Current Liabilities}}{\text{Net Worth}}$$

Example: For fiscal year 1973, the NEX ratio is (75,616) ÷ (156,238) or 48.4 percent.

(6) Current Liabilities To Inventory. This ratio yields another indication of the extent to which the business relies on funds from disposal of unsold inventories to meet its debts. It is computed as follows:

$$\text{Current Liabilities To Inventory} = \frac{\text{Current Liabilities}}{\text{Merchandise Inventory}}$$

Example: For fiscal year 1973, the NEX ratio is (75,616) ÷ (135,458) or 55.8 percent.

b. Capital Structure and Long-Term Solvency

(1) Total Debt to Net Worth. When this relationship exceeds one hundred percent, the equity of creditors in the assets of the business exceeds that of the owners. It is computed as follows:

156,238) or 52.8 percent.

to Net Worth. Fixed assets

es of buildings, building improve-

fixtures, tools, and other

valued at cost or appraised

reet indicate that ordinarily,

exceed seventy five percent for

is computed as follows:

$$\text{Worth} = \frac{\text{Fixed Assets}}{\text{Net Worth}}$$

fiscal year 1973, the NEX

or 19.5 percent.

Working Capital. Net working

available to the business for

ivables, and for financing day-

could also be considered a

ce as well since it does include

mputed by dividing net income

capital as follows:

$$\text{apital} = \frac{\text{Net Income}}{\text{Net Working Capital}}$$

Example: For fiscal year 1973, the NEX ratio is (55,877) ÷ (184,839 - 75,616) or 51.2 percent.

c. Return on Investment

(1) Return on Equity Capital. This ratio is generally regarded as a fundamental test of true profitability. It relates income to the amount of investment that was committed to earning the income. To measure the profitability of any investment, whether for a company, a project, or an individual investment, the amount of income must be gauged against the resources invested. This ratio is computed as follows:

$$\text{Return on Equity Capital} = \frac{\text{Net Income}}{\text{Equity Capital}}$$

Example: For fiscal year 1973, the NEX ratio is (55,877) ÷ (120,135) = 46.5 percent. This ratio is difficult to compare to the commercial sector because of the lack of shareholders equity in the NEX program.

(2) Return on Total Assets. This is another view of the ROI concept which relates net income to the total assets used rather than just to equity capital. It can be considered a measure of return on all of the resources employed during the year. This is often viewed as a fundamental measure of management's performance in using all of the resources available. It is computed as follows:

$$\text{Return on Total Assets} = \frac{\text{Net Income Before Interest And Taxes}}{\text{Total Assets}}$$

Example: For fiscal year 1973, the NEX ratio is (55,877) ÷ (238,697) or 23.4 percent.

d. Asset Utilization

(1) Sales to Inventories. This ratio is a form of calculating inventory turnover. This quotient does not yield an actual physical turnover. It provides, instead, a yardstick to compare stock-to-sales ratios of a concern with industry averages. It is computed as follows:

$$\text{Sales to Inventory} = \frac{\text{Net Sales}}{\text{Inventory}}$$

Example: For fiscal year 1973, the NEX is (977,403) ÷ (135,458) or 7.2 times.

(2) Net Sales to Working Capital. This ratio provides a guide as to the extent the company is turning its working capital and the margin of operating funds. It is computed as follows:

$$\text{Net Sales To Working Capital} = \frac{\text{Net Sales}}{\text{Net Working Capital}}$$

Example: For fiscal year 1973, the NEX ratio is (977,403) ÷ (184,839 - 75,616) or 8.9 times.

(3) Net Sales to Fixed Assets. This ratio indicates the extent to which the company is utilizing its net

fixed assets in generating its revenue. It is computed as follows:

$$\text{Net Sales to Fixed Assets} = \frac{\text{Net Sales}}{\text{Net Fixed Assets}}$$

Example: For fiscal year 1973, the NEX ratio is (977,403) ÷ (30,499) or 32.0 times.

(4) Net Sales to Total Assets. This ratio is frequently called asset turnover. It provides an indication as to the size of asset commitment required for a given level of sales, or, conversely, the sales dollars generated for each dollar of investment. It is computed as follows:

$$\text{Asset Turnover} = \frac{\text{Net Sales}}{\text{Total Assets}}$$

Example: For fiscal year 1973, the NEX asset turnover is (977,403) ÷ (238,697) or 4.1 times.

(5) Net Sales to Net Worth. This ratio simply gives a measure of relative turnover of invested capital. It is computed as follows:

$$\text{Net Sales to Net Worth} = \frac{\text{Net Sales}}{\text{Net Worth}}$$

Example: For fiscal year 1973, the NEX ratio is (977,403) ÷ (156,238) or 6.3 times.

e. Operating Performance

(1) Gross Margin Ratio. This ratio compares the relationship of gross profit to net sales. Gross profit is the difference between net sales and cost of sales. It is computed as follows:

$$\text{Gross Margin Ratio} = \frac{\text{Gross Profit}}{\text{Net Sales}}$$

Example: For fiscal year 1973, the NEX gross margin ratio is (250,931) ÷ (977,403) or 25.7 percent.

(2) Net Income to Net Worth. According to Dun and Bradstreet, this ratio is looked at increasingly as a final criterion of profitability. Generally, a relationship of at least ten percent is regarded by Dun and Bradstreet as a desirable objective for providing dividends plus funds for growth. It is computed as follows:

$$\text{Net Income to Net Worth} = \frac{\text{Net Income}}{\text{Net Worth}}$$

Example: For fiscal year 1973, the NEX ratio is (55,877) ÷ (156,238) or 35.8 percent.

(3) Net Income to Net Sales. This ratio simply expresses the percent of each sales dollar, on the average, that represents profit. This ratio is frequently called the profit margin. It is computed as follows:

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Net Sales}}$$

SUMMARY OF FINANCIAL RATIOS

	1978	1977	1976	1975	1974	1973
CURRENT RATIO	2.25	2.40	2.58	2.66	2.83	2.44
ACID TEST RATIO	0.67	0.64	0.70	0.73	0.43	0.63
INVENTORY TURNOVER	5.64	5.65	5.76	5.49	5.31	5.49
INVENTORY TO NET WORKING CAPITAL	122.6%	121.9%	116.4%	113.5%	129.1%	124.0%
CURRENT LIABILITIES TO NET WORTH	54.7%	48.3%	42.5%	40.4%	38.2%	48.4%
CURRENT LIABILITIES TO INVENTORY	65.4%	58.6%	54.2%	53.2%	42.4%	55.8%
TOTAL DEBT TO NET WORTH	58.5%	51.9%	46.1%	43.8%	41.9%	52.8%
FIXED ASSETS TO NET WORTH	26.7%	26.7%	28.2%	30.0%	26.4%	19.5%
NET INCOME ON WORKING CAPITAL	36.4%	35.0%	38.7%	40.5%	45.8%	51.2%
RETURN ON EQUITY CAPITAL	28.6%	29.7%	32.7%	34.2%	41.2%	46.5%
RETURN ON TOTAL ASSETS	15.6%	15.6%	17.8%	18.8%	22.6%	23.4%
NET SALES TO INVENTORY	7.3	7.4	7.6	8.0	6.8	7.2
NET SALES TO WORKING CAPITAL	8.9	9.0	8.9	9.1	8.8	8.9
NET SALES TO FIXED ASSETS	22.8	22.8	21.1	20.2	23.4	32.0
ASSET TURNOVER	3.8	4.0	4.1	4.2	4.3	4.1
NET SALES TO NET WORTH	6.1	6.1	6.0	6.1	6.2	6.3
GROSS MARGIN	25.2%	25.2%	26.2%	26.2%	26.0%	25.7%
NET INCOME TO NET WORTH	24.8%	23.7%	26.0%	27.1%	32.1%	35.8%
PROFIT MARGIN	4.1%	3.9%	4.4%	4.5%	5.2%	5.7%

EXHIBIT III-13

Example: For fiscal year 1973, the NEX profit margin is (55,877) ÷ (977,403) or 5.7 percent.

The tabular summary of the ratio computations for the NEX Program is presented as Exhibit III-13. To provide a more visible indication of the trends presented in the tabular summary, the author has plotted, in graphical form, each ratio versus the six fiscal years included in the study. As an added dimension to the graphic display of the NEX ratio trends the author has concurrently plotted the trends of selected business ratios for private sector department and discount stores as published by Dun-Bradstreet. These graphs are presented as Exhibits III-14 through III-32.

E. SHORT-TERM LIQUIDITY

Interpretation of the data through quantitative analysis indicates, for the most part, a very consistent liquid position for the NEX Program. The various indicators used in evaluating short-term liquidity do provide, however, some varying trends as well as fluctuations during the six year period of concern. A brief discussion of each indicator will amplify these differences.

The trend of the current ratio is graphically displayed in Exhibit III-14. The trend is very consistent over the six year period, particularly from 1974 where an extremely consistent decline persists through 1978. Of particular interest is the comparison of the NEX ratios to the private sector ratios. The NEX current ratios fall well within the

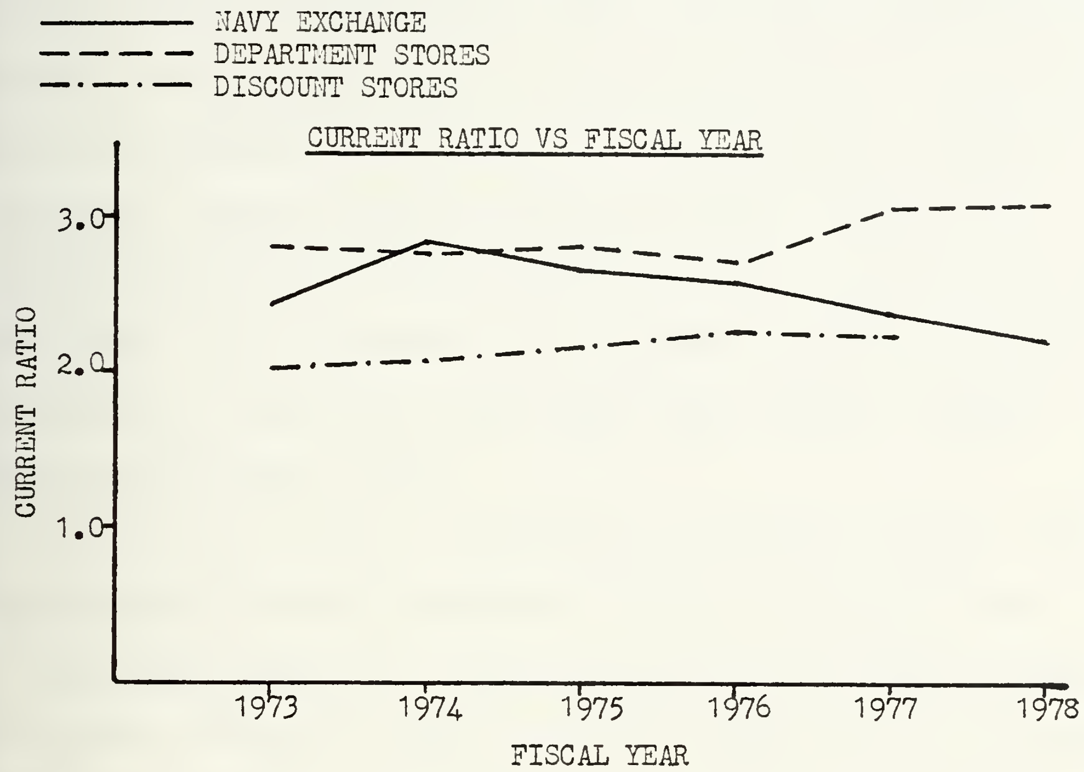


EXHIBIT III-14

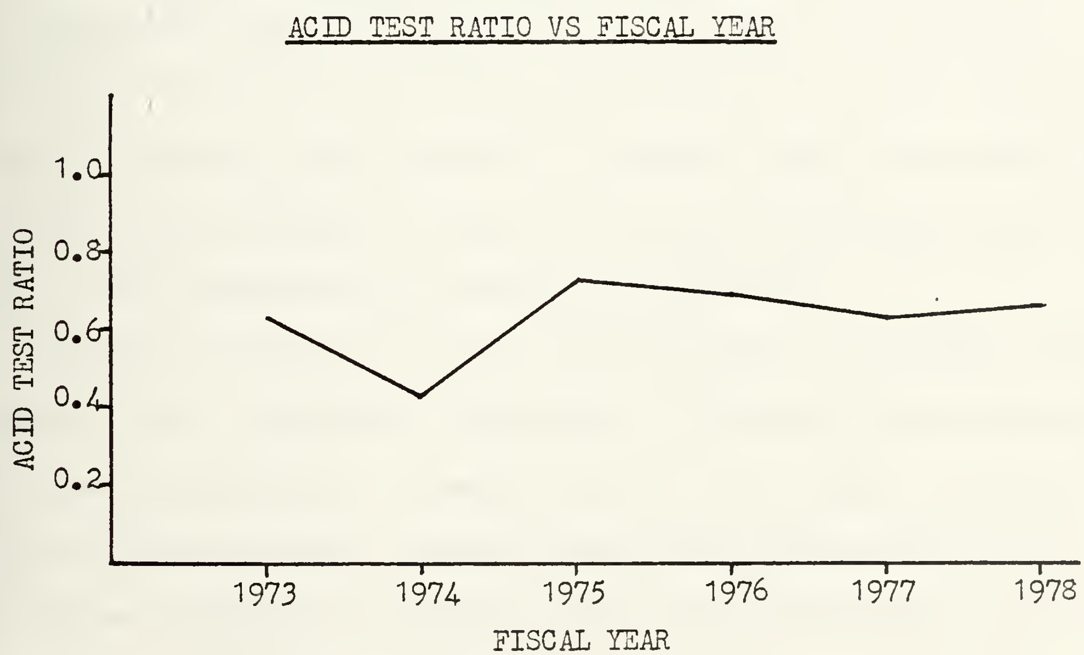


EXHIBIT III-15

range of those of the private sector department and discount stores, however, the trends differ in direction. The private sector ratios tend to show gradual increases for the most part, while the NEX ratios display gradual, but more pronounced, decreases for most of the period. A review of Exhibits III-10 and III-11 indicates that current liabilities have increased at a more rapid pace than have current assets, hence the declining trend.

The acid test ratios, presented in Exhibit III-15, displayed somewhat less consistency during this period than did the current ratios. Fiscal year 1974 provided the most significant variation from what would otherwise be reasonably consistent figures. A review of the financial statements indicate this low ratio of 0.43 in 1974 resulted primarily from greatly reduced cash assets. Though no ratios for the private sector were utilized for comparison, an acid test ratio of 0.6 to 0.7 is fairly strong in view of the ready-to-sell, highly liquid nature of the NEX retail inventories.[66] The very stable nature of the acid test ratio since 1975 is also a good indicator of the NEX's liquidity.

Inventory turnover for the NEX Program is the most consistent of all liquidity indicators. Exhibit III-16 displays the trend graphically, showing only a very slight increase in the turnover ratio. Though Dunn and Bradstreet do not provide an inventory turnover ratio for comparison to the private sector, a similar ratio, sales to inventory, is

INVENTORY TURNOVER VS FISCAL YEAR

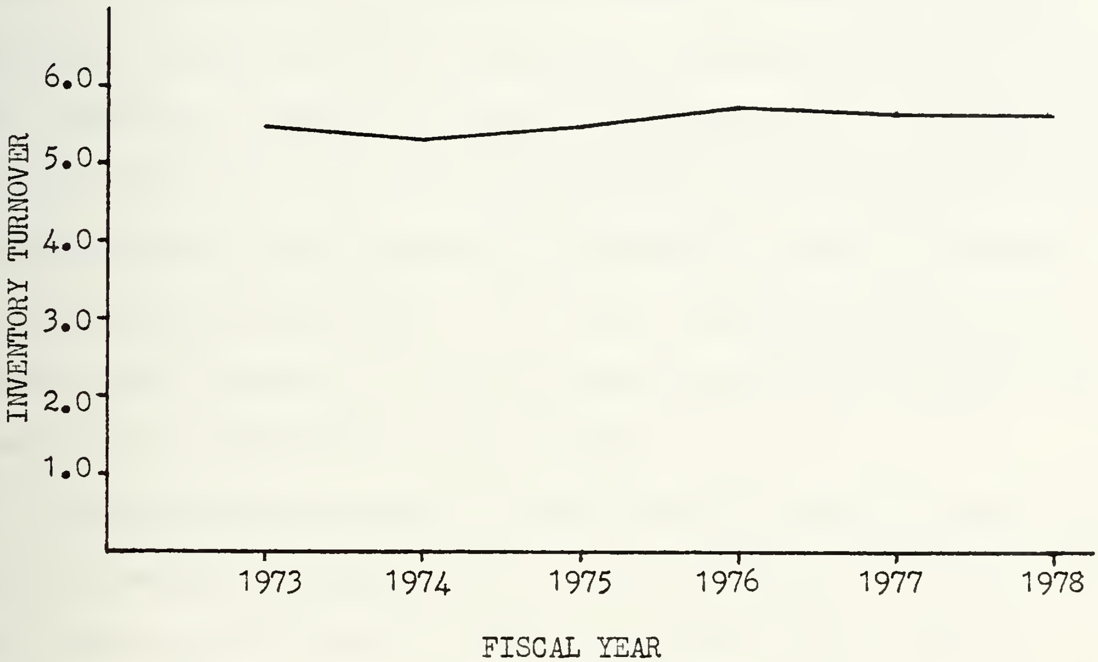


EXHIBIT III-16

INVENTORY TO NET WORKING CAPITAL VS FISCAL YEAR

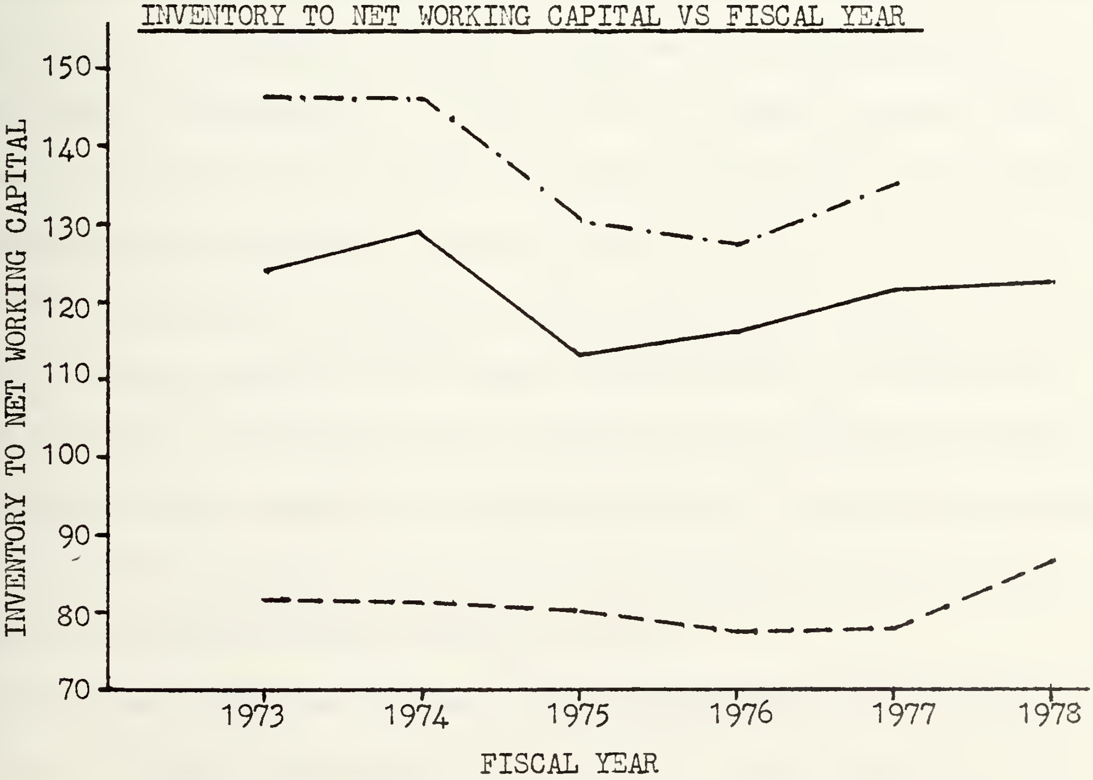


EXHIBIT III-17

available. In all cases in the private sector the sales to inventory ratio is below the NEX turnover ratio. Exhibit III-25, a comparison of NEX and private sector net sales to inventory ratios is also occasionally referred to as inventory turnover. Though it does not measure the true magnitude of the turnover, it most certainly expresses the comparative relationship of the inventory turnover for the NEX Program versus the private sector. The NEX ratios are consistently strong when compared to the private sector and indicate the inventory is apparently very liquid.

In comparing inventory to net working capital using the graph presented as Exhibit III-17, the results appear to be very nearly the inverse of the acid test ratio, Exhibit III-15. The plot is characterized by fluctuations in the early years followed by four years of consistently increasing ratios, the velocity of the increases also appearing to be reasonably consistent. It falls in the upper area of the range created by the private sector trend lines, more closely resembling the discount store ratios.

The financial statements again provide a surface indication of the causes of the ratio fluctuations. Both major fluctuations, 1974 and 1975, appear to be primarily driven by substantial changes in the inventory. The overall trend of the NEX inventory to net working capital ratio is very similar to the private sector trends.

The last area to peruse in the discussion of liquidity is that of the relationship of current liabilities to both

net worth and inventory, Exhibits III-18 and III-19. The trends of both ratios are extremely similar.

The NEX current liabilities to net worth percentage is consistently well below discount store percentages, but is, however, above department store percentages over the past three years. Though both types of private sector stores have more pronounced fluctuations than the NEX, the overall change during the six year period has been a decrease in their ratios. The NEX, on the other hand, has had consistently increasing ratios with the trend line having a substantial slope. The current liabilities to inventory ratios of Exhibit III-19 provide similar results. While the NEX ratios demonstrate a relatively consistent, steep increasing trend since 1974, the private sector ratios fluctuate a great deal more, but ultimately have an overall decrease in the ratios.

From review of the financial statements the apparent cause of the NEX's increasing trend in both cases is rapidly increasing current liabilities; a sixty percent increase from 1974 to 1978. The denominators in the ratios, net worth and inventory, reflected modest increases of twelve and four percent respectively. Though these two ratios currently are no particular cause for alarm as they compare favorably to private sector ratios, the magnitude, velocity, and direction of the trends should cause some consternation to management. As the accounts payable appear, for the most part, to be the driving force in the increasing current liabilities, the

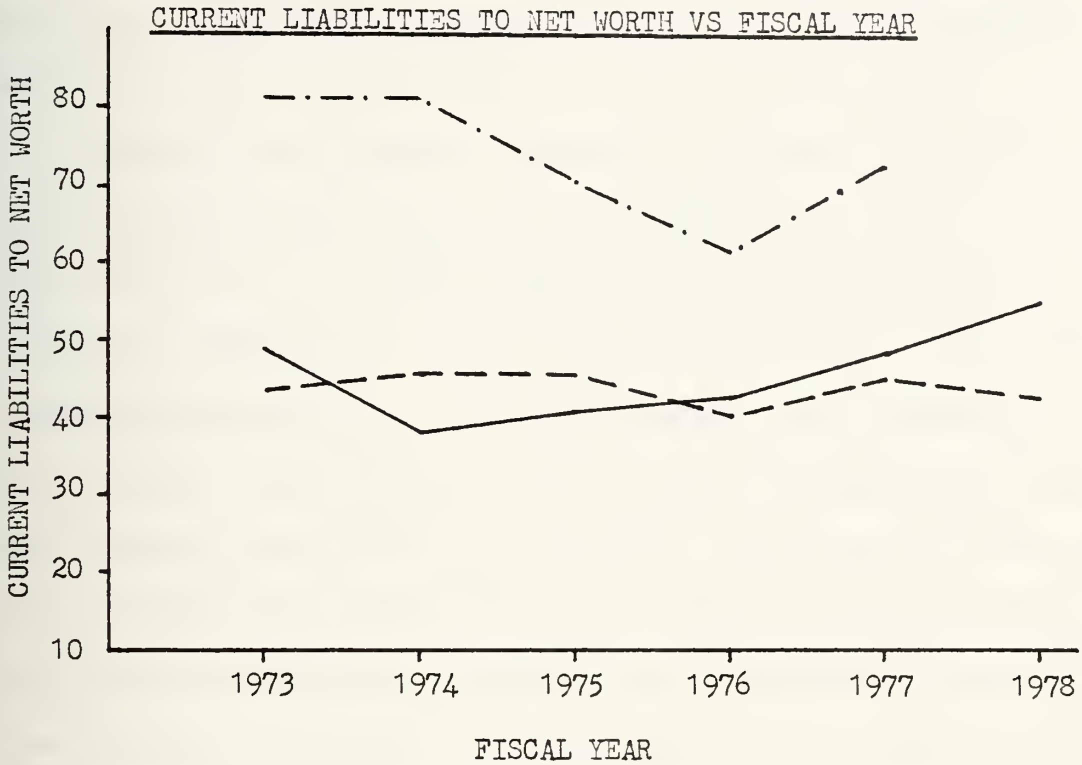


EXHIBIT III-18

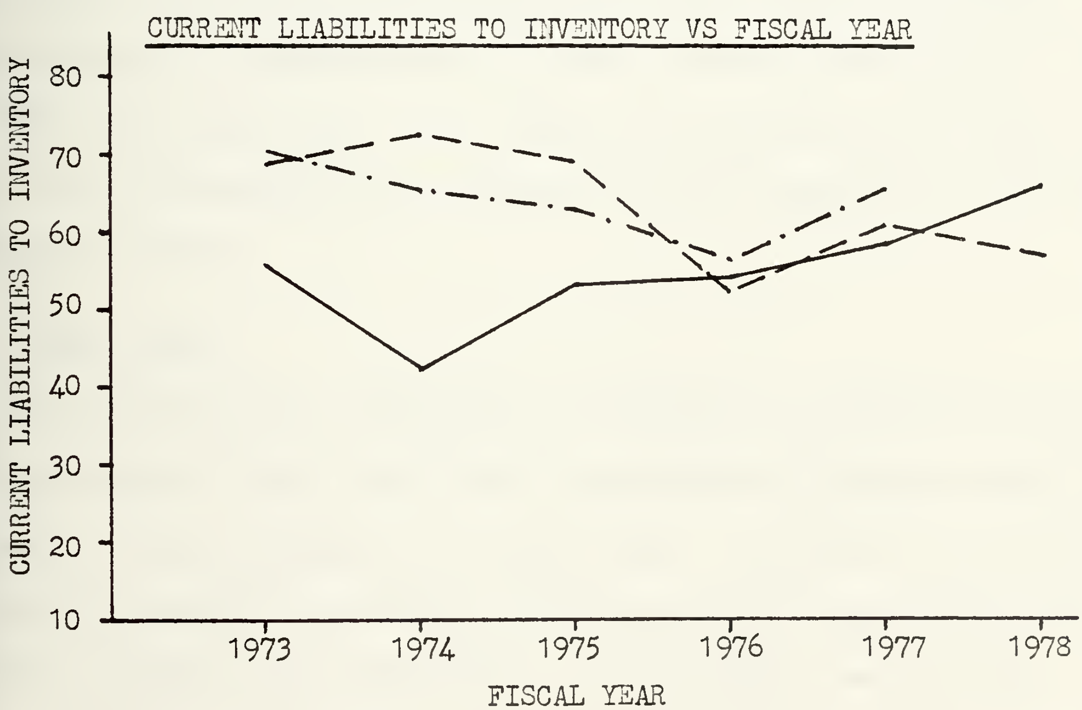


EXHIBIT III-19

author feels that increased management attention to this area of the financial operation appears to be a worthwhile objective.

In terms of the current indicators of short-term liquidity, the NEX Program demonstrates a reasonably consistent, strong liquid position. In relationship to the private sector, the NEX Program displays very favorable comparisons to the industry operating ratios for retail department and discount stores. There are, however, some current trends which indicate a changing position of liquidity. The rapidly increasing current liabilities appear to be the primary driving force in all of the unfavorable trends. It contributes directly to the decreasing current and acid test ratios; indirectly to the increasing inventory to net working capital ratio; and directly to the more pronounced increases of the current liabilities to inventory and current liabilities to net worth ratios. In most cases, the trends displayed are contrary to the retail department and discount store trends for this same period of time.

F. FUNDS FLOW

The comparative statements of changes in financial position, Exhibits III-7 and III-8, provide the primary source of input for the discussion of funds flow. Exhibit III-7 displays the sources and uses of working capital excluding the current assets and liabilities. In so doing, an overall change in working capital is derived for each year. Exhibit

III-8 then substantiates this derived figure by using an analysis of current assets and liabilities. Each exhibit will be discussed individually.

Exhibit III-7 indicates that virtually all of the sources of working capital for the NEX are directly from operations. Comparatively insignificant amounts are provided by the remainder of the various sources listed. Uses of working capital, however, consist of three major items listed in the statement; distributable income, increases in equipment, and buildings and building improvements. The latter two items can be effectively categorized as funds reinvested in the program. The largest use of funds is for distributable income; funds provided to support the Navy's welfare and recreation programs. Distributable income represents approximately sixty five to seventy percent of all uses of working capital in the NEX Program.

Reinvestment in the NEX Program, the other major use of capital, represents approximately twenty to thirty five percent of the total uses in the program. This category combined with distributable income accounts for an average of ninety-plus percent of all uses of working capital. Overall, the exhibit demonstrates that the sources and uses of capital in the NEX Program are in congruence with the stated program missions delineated in Chapter Two.

An analysis of the changes in working capital using current assets and liabilities is presented in Exhibit III-8. Close review of this analysis reveals four major areas of interest.

The first, considered most significant by the author, is the very large increases in the accounts payable; 42.8 percent since 1973. If one begins with the low point of 1974, accounts payable have increased 68.4 percent. Perhaps the most significant point is the eleven million dollar increases in payables in each of the last two years. This data substantiates the trends discussed in the analysis of liquidity, and again accounts payables appear to be the major contributor to the trend. As an increasing payables account represents a source of funds within an operation, the force or impetus which drives this current increasing trend deserves review. This will be discussed in the concluding chapter.

The three other areas of interest are uses of funds. The first of these uses is increasing merchandise inventory. From 1976 to 1978 increasing inventory represents the largest use of funds in the analysis of changes in current assets. In 1975, it represented a tremendous source of funds; over nineteen million dollars. Since that time, however, NEX inventories have grown by seven to ten million dollars annually; a 5.4 to 6.9 percent growth rate. During this same period sales growth varied from a mere 0.3 percent to 5.8 percent while net income declined 1.8 and 9.0 percent respectively for 1976 and 1977; bouncing back in 1978 with a 10.7 percent increase. These figures indicate some noticeable inconsistencies.

Increasing accounts receivable also reflect a use of funds. Since 1975, where receivables were a source of slightly

over a million dollars, trade and accounts receivable have grown 85.0 percent. In 1978 they represented nearly twenty million dollars worth of current assets.

The last area of interest is the short-term investments. While displaying a decrease in 1974, short-term investments have increased by over twenty million dollars since that time, a growth rate of 192.2 percent. This is particularly interesting when compared to interest income changes over the same period of time. Exhibit III-6 displays interest income as fluctuating throughout the entire period. The high point in 1978 is however, only about one percent higher than the 1974 figure. The relationship of short-term investments to interest income appears to be inconsistent at best. Realizing the interest income represents earnings over the entire year and short-term investments on the balance sheet represent the investments active only at that time, the "snapshot" presented requires more detailed information to clarify the apparent inconsistency; information not immediately available to the author.

The funds flow analysis has substantiated that the sources and uses of working capital in the NEX Program are currently consistent with the mission of the program; the primary source is income and the primary uses are distribution to recreation funds and reinvestment in the program. Analysis of sources and uses in current assets and liabilities highlights some interesting trends which the author cannot

thoroughly evaluate without more detailed information. These trends are worthy of comment in the next chapter.

G. CAPITAL STRUCTURE AND LONG-TERM SOLVENCY

Section E of this chapter provided insight into the NEX Program's ability to meet its current financial obligations; its liquidity. This section devotes effort to looking at the program's ability to fulfill its obligations in the long run, beyond the current accounting year; its solvency. The most effective method of presenting this financial characteristic is to look at the program's capital structure. Where are its funds invested?

The first indicator to be discussed is the ratio of total debt to total net worth. In other words, how much of the program is indirectly "claimed" by creditors? Exhibit III-20 presents the trends demonstrated by this ratio over the six year period of study. With the exception of the decline from 1973 to 1974, the NEX Program's total debt has been increasing faster than its net worth. Utilizing the figures from Exhibit III-5, the total debt increased nearly seventy five percent from 1974 to 1978 while the net worth increased only a fraction of that; a modest twelve percent. Because of the lack of long term debt in the exchange program, the primary source of this trend is again current liabilities, hence, accounts payable.

Comparing the NEX ratios to the private sector ratios, one finds the private sector trend lines with sharp fluctuations in the past few years. In all but the 1978 department

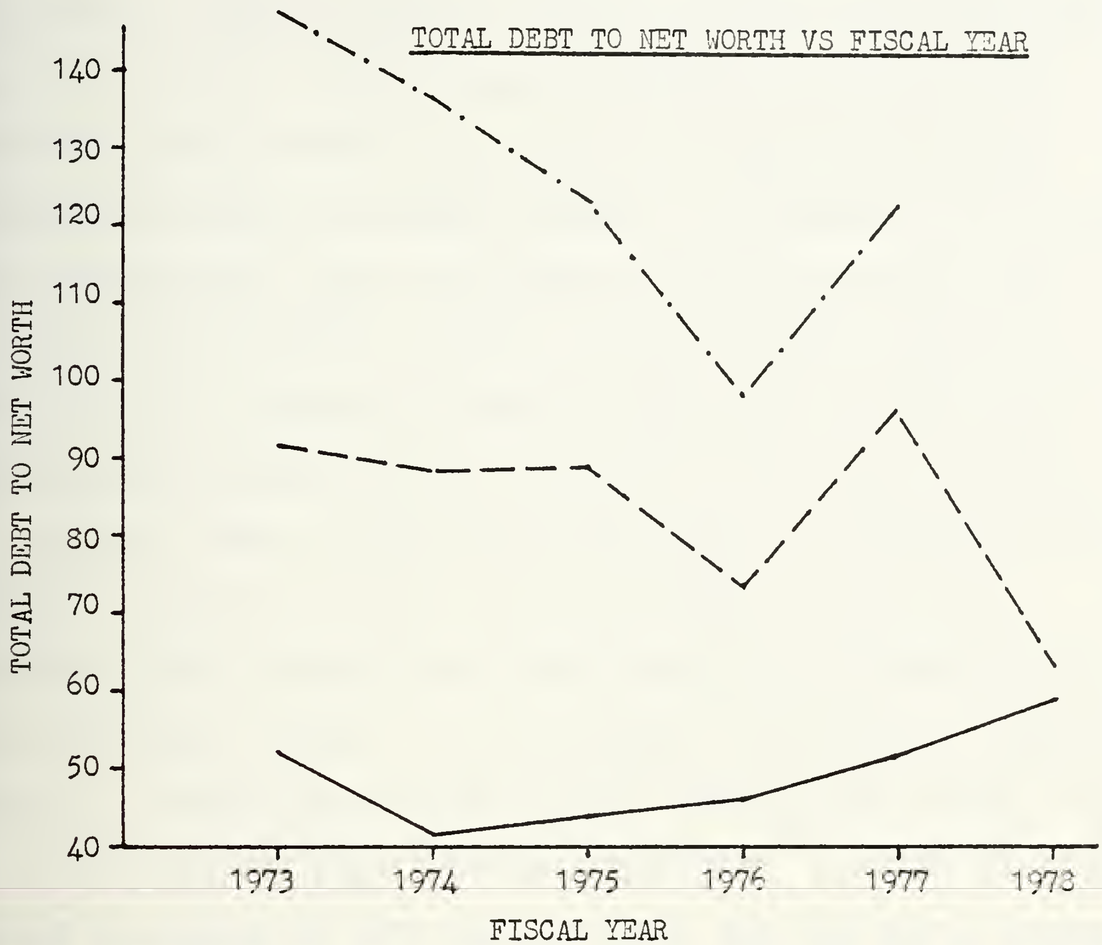


EXHIBIT III-20

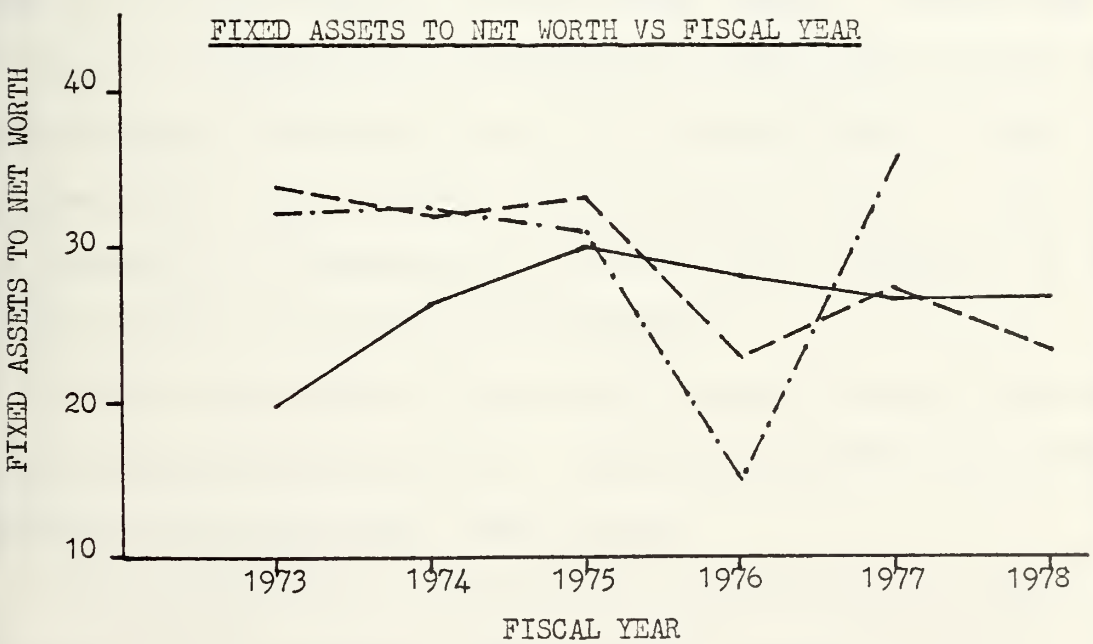


EXHIBIT III-21

store ratio, private sector ratios were well above the NEX ratios. However, the NEX has a definite increasing trend and the private sector stores have an overall decreasing trend with occasional upward spikes. It appears to the author that the NEX will soon have debt to net worth ratios very similar to the private sector. If the overall trends continue it is not unlikely that the NEX ratios could exceed those of the private sector in the not too distant future.

Another ratio to which one can refer in a discussion of capital structure is that of fixed assets to net worth. Exhibit III-21 portrays the relationships of the NEX to the private sector trends. It is somewhat difficult to identify trends in the private sector ratios, there being large fluctuations in their magnitude and direction. The NEX displayed strong increases in 1973 through 1975, but has had a gradual decline since that time. Referring to Exhibit III-5, one finds very minute changes in net fixed assets. Though the net worth of the NEX has not changed a great deal either; a twelve percent increase since 1974; the magnitude of its changes drives this ratio. The decline from 1975 to 1978 is due primarily to increasing net worth, not a reduction in fixed assets as might initially be suggested.

The NEX fixed asset to net worth ratios compare favorably to the private sector ratios. Currently the NEX more closely resembles the department store ratios.

The last indicator of solvency to be utilized in this discussion is the ratio of net income to working capital. This

addresses whether the working capital is really working. No matter how one approaches the discussion, Exhibit III-22 displays graphically, that indeed it is working.

The NEX ratios are well above the private sector ratios throughout the period of study, however, the difference has decreased dramatically. The NEX overall trend is a sharp decline in the ratio while private sector ratios demonstrate very slight increases. The NEX does experience a slight up-turn in 1978 which may be an indication of a change in the trend.

Referring to Exhibits III-6 and III-7, it would appear that the NEX net income is the driving force in this ratio. While net working capital has fluctuated between increases and decreases, the net income has shown steady decline through 1977 with 1978 being the first sign of any change.

The snapshot of the exchange capital structure indicates that it is an extremely solvent operation through the near future. The distant future, say five to ten years out, does not have as strong a set of supporting indicators. Current trends display significantly increasing debt to net worth and decreasing net income to working capital. These trends should they continue, would suggest a less and less solvent position for the NEX in the future.

H. RETURN ON INVESTMENT

The measure of return on investment can take a variety of forms. Because of the nature of the NEX financial structure,

NET INCOME ON WORKING CAPITAL VS FISCAL YEAR

EXHIBIT III-22

only two ratios are utilized in this discussion. It is worthwhile to remind the reader that NEX management has established an ROI hurdle rate of fifteen to twenty percent for the total annual project budget. As ROI is not one of the business ratios provided by Dunn and Bradstreet in their annual summaries of key operating ratios, the internal requirement provides the only scale by which to measure performance.

Exhibit III-23 presents the NEX Program's return on equity capital. Because the NEX has no actual shareholders, the author utilized only reinvested earnings at the end of each fiscal year as the NEX equity capital. The trend which develops from plotting the ratios using this approach is a rapidly declining curve, having a fairly consistent slope. Review of Exhibit III-10 and III-11 indicates that the strong trend results from both declining net income and increasing reinvested earnings. Because the income distribution of the NEX is designed to provide earnings for reinvestment in capital projects regardless of the magnitude of the net income, the validity of this ratio as a source of measuring ROI performance is uncertain. It would appear to the author that if NEX management is in fact obtaining the ROI's projected in the annual project budgets, the trend line presented should level off in the fifteen to twenty percent range. However, if the reader recalls, minor projects, those under $10,000, are not subject to the ROI hurdle rate. Hence, approval of an increasing number of minor projects could

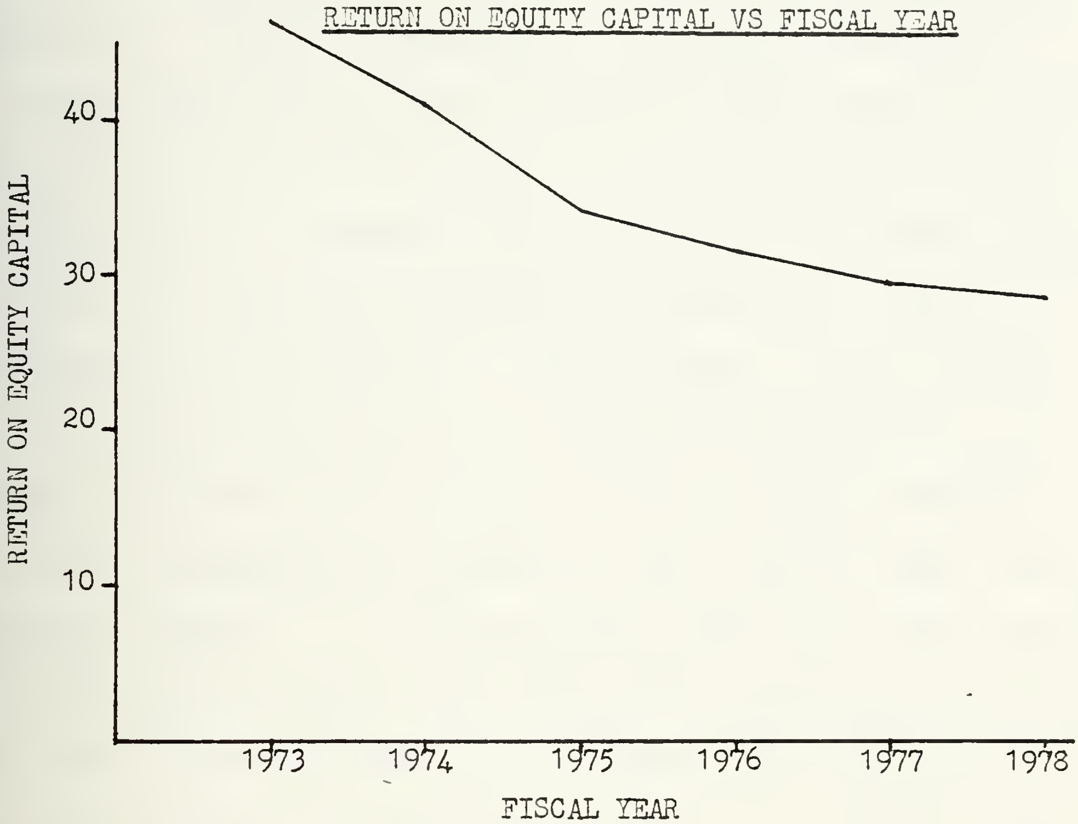


EXHIBIT III-23

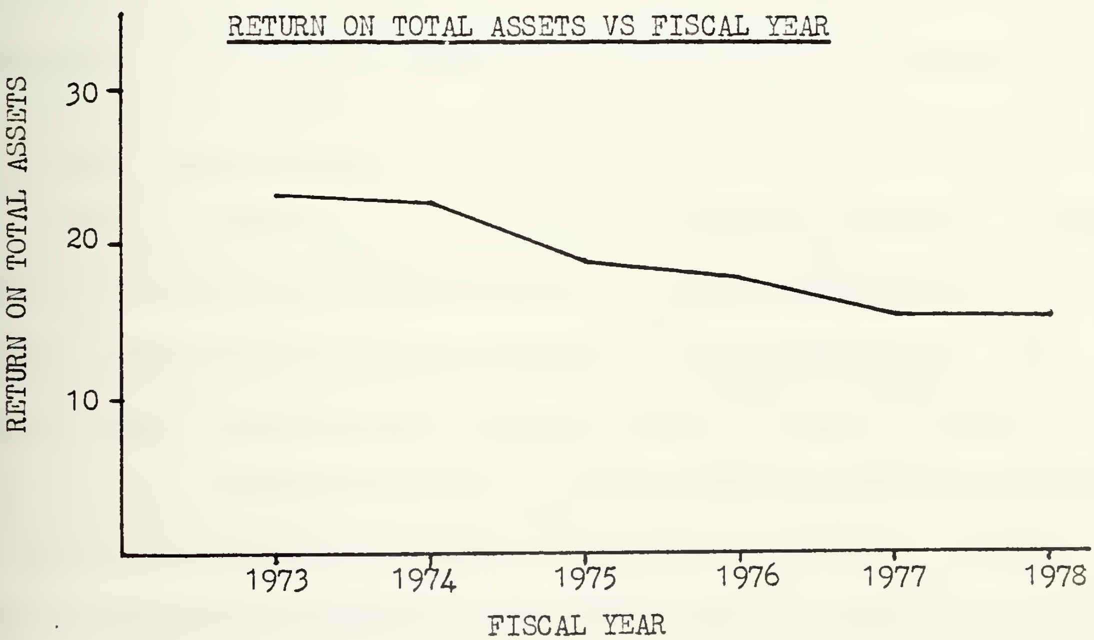


EXHIBIT III-24

drive the curve below fifteen percent depending on their nature, i.e., profit producing or non-profit projects.

The second ratio, return on total assets, Exhibit III-24, provides the same declining trend as return on equity capital. It is, however, not declining at the same velocity. In fact, 1977 and 1978 indicate a leveling off trend at approximately 15.6 percent. This appears, to the author, to be relatively consistent to the ROI hurdle rate. It occurs as a result of a slightly increased net income in 1978 and a comparable increase in total assets, both just above ten percent. If this one year marks the end to the declining trend of the past five years, it would appear to the author that NEX management is doing an exceptional job in their project evaluation and review. If, however, the trend returns to its declining nature, a review of project evaluation procedures would be in order. Some additional comments on ROI are offered in the concluding chapter.

I. ASSET UTILIZATION

Another aspect of evaluating a large corporation is the review of its asset utilization. Are the corporation's assets being effectively utilized in the operation? Are there "idle" assets whose contribution to the operation is nill or negligible at best? In reviewing the NEX operating ratios of asset utilization, it appears as if the overall assets are being employed reasonably well in the operation.

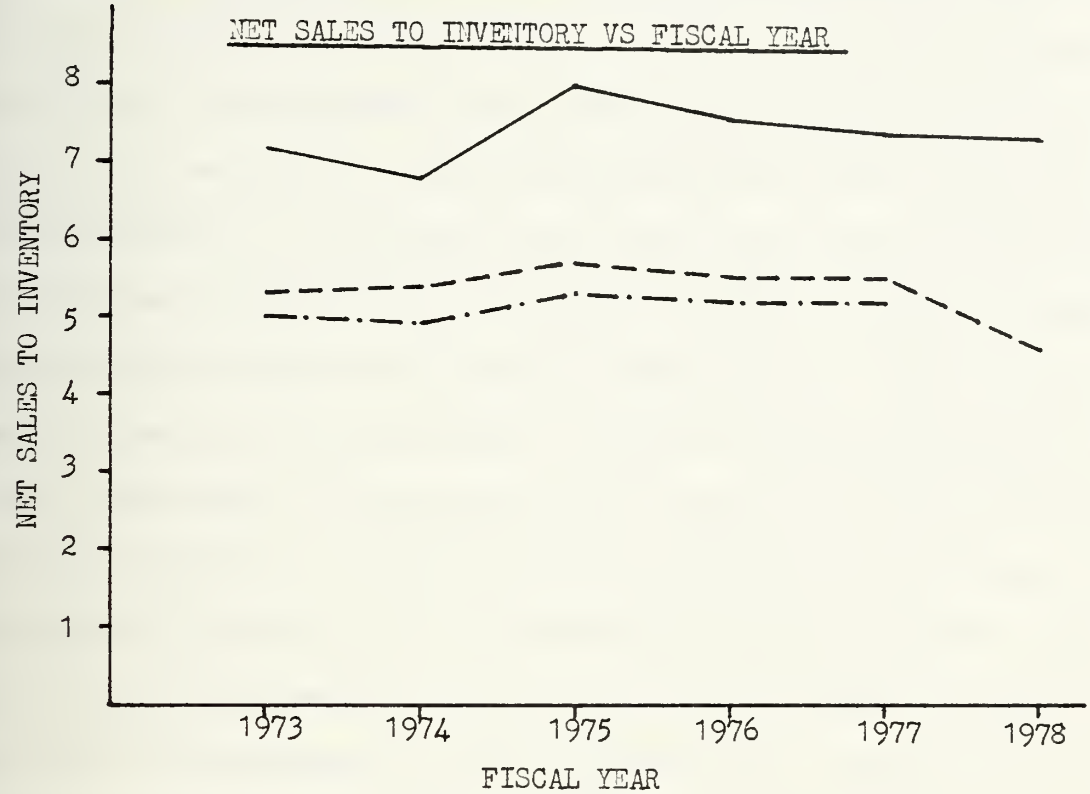


EXHIBIT III-25

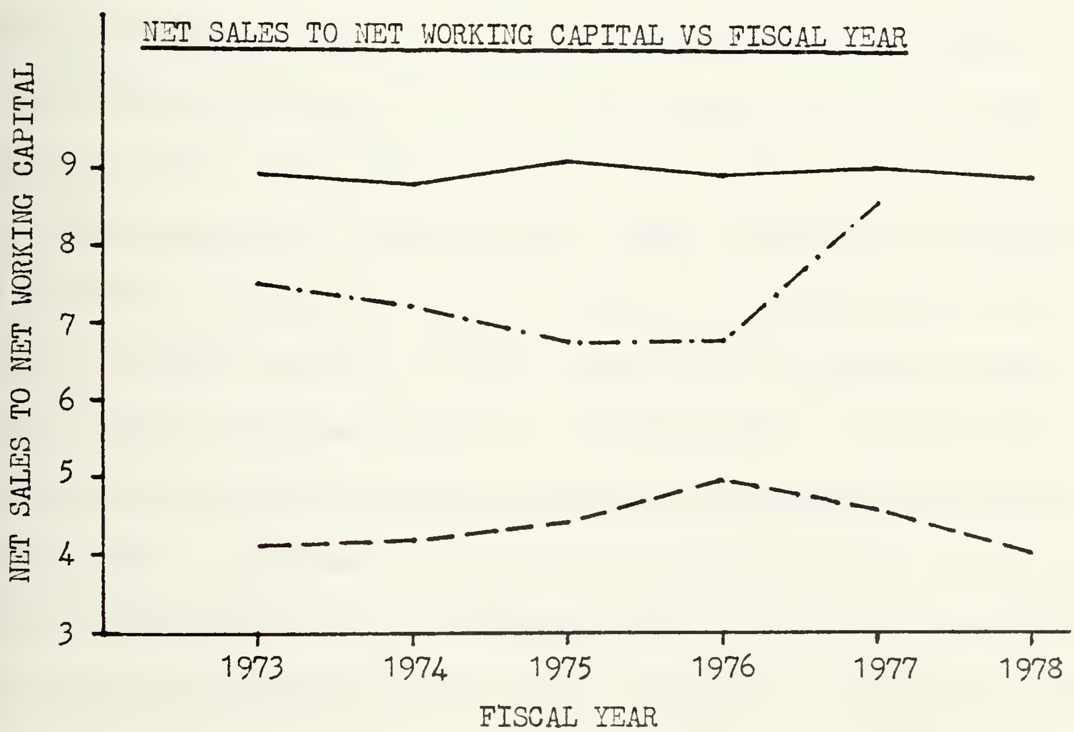


EXHIBIT III-26

The first ratio indicator to be discussed is the net sales to inventory ratio, Exhibit III-25. This ratio allows one to look at management policies regarding stock-to-sales ratios, the amount of inventory allowed per dollar of sales. Interpretation of the graph could lead one to believe that for every dollar invested in inventory, the NEX produces a greater volume of sales than the private competition. This is a misleading measure of performance. Stock-to-sales ratios are usually specified by department as a matter of policy within a retail operation. The NEX is no exception. A surface evaluation of Exhibit III-25 might lead one to believe that the NEX is "doing better" than its private sector counterparts in the management of its inventories. However, this is not necessarily the case. Consider a hypothetical retail operation which is nearly out of stock of every item carried with no inventory on order at the end of the accounting period. Its net sales (assuming it did have sales during the year) to inventory ratio will be extremely high. Yet, few would argue that the company has demonstrated good inventory management. The author's interpretation of the trend displayed in Exhibit III-25 is that the NEX has more restrictive stock-to-sales ratios than its private sector counterparts. A basis for this interpretation revolves around the difference in mark-on percentages. Consider the volume of widgets sold and widgets held in inventory for the exchange and a private sector retail store to be exactly the same. Further assume that both organizations experience the same cost price for each widget.

The author contends that the private sector operation would have the higher sales to inventory ratio because of a higher mark-on applied to its widgets. This higher sales to inventory ratio translates, through an inverse function, to a lower stock-to-sales ratio for the private sector. One might conclude from this example that the private sector will always have lower stock-to-sales ratios than the NEX because of its policy to maximize sales through a larger mark-on. The data, however, indicates quite the contrary. The NEX sales to inventory ratios are well above those of the private sector for each year studied. This phenomenon results from the NEX policy regarding the numerator of this ratio, inventory. Though NEX sales are proportionally lower than private sector sales due to lower mark-on percentages, which would result in a comparatively higher stock-to-sales ratio; the far more restrictive NEX policy on inventories more than offsets the difference. Hence, the NEX stock-to-sales ratios are much lower than those of the private sector. Additional comments will be provided in the concluding chapter.

The next indicator to be discussed is the ratio of net sales to net working capital, Exhibit III-26. The trend demonstrated is virtually flat, indicating a direct relationship of sales to net working capital. Because sales revenue is the primary source of working capital and the NEX has a fairly stable investment program, it is anticipated by the author, that this ratio should be reasonably stable as well.

It is interesting to note the comparison to private sector enterprises. Both department and discount stores have lower ratios than the NEX and both display less consistency. The NEX would appear to be effectively turning its working capital.

Net sales to fixed assets, displayed in Exhibit III-27, provides an indication that the NEX is not a capital intensive operation. Additional review of Exhibit III-5 substantiates this; fixed assets being only approximately twenty percent of the NEX total assets. This compares favorably to the retail industry as a whole which has a 22.3 percent fixed asset to total asset ratio.[67] The leveling trend from 1974 to 1978 seems to reflect NEX management's increased attention on its construction program and its relationship to sales volume and customer satisfaction.[68]

The asset turnover ratio, net sales divided by total assets, also indicates a good turnover of total assets in the NEX operation. The graphic display of Exhibit III-28 indicates extremely consistent ratios throughout the six year period. Though it is very gradual, the trend has been declining since 1974. The cause of the decline is readily apparent using Exhibits III-10 and III-11. The index numbers for net sales increased gradually over the six years to a high of 116.2. Total assets, however, have had an even greater increase, reaching a high of 123.9. These trends, of course, when combined into a ratio, result in the trend of Exhibit III-28.

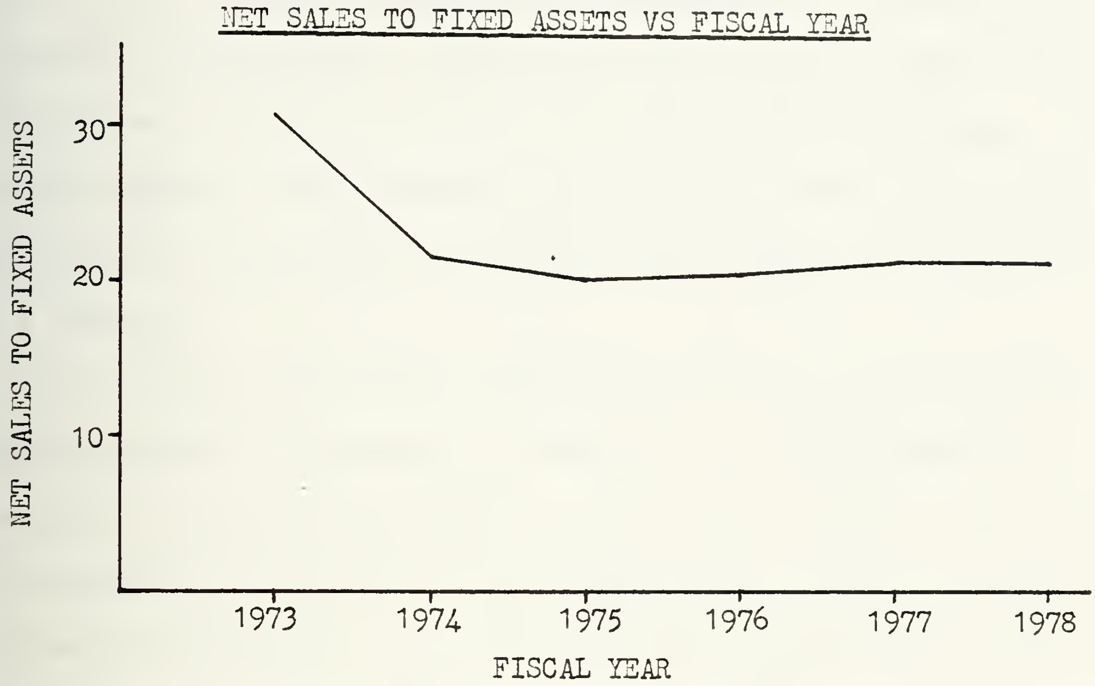


EXHIBIT III-27

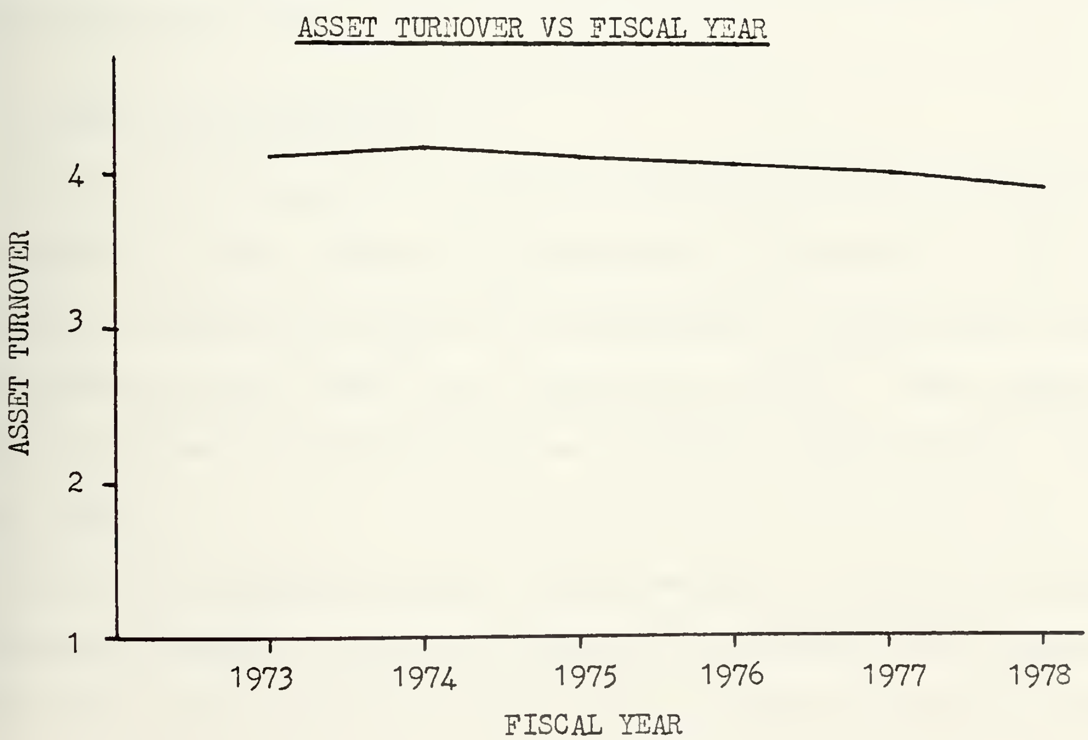


EXHIBIT III-28

The last ratio to be discussed in this section is net sales to net worth. Graphically displayed in Exhibit III-29, it demonstrates similar characteristics as the asset turnover, though the magnitude of the ratios are somewhat larger. The ratios compare very favorably to private sector operations, and the ever so slight declining trend would not appear to be a concern.

All of the indicators discussed tend to indicate that the NEX does employ its assets effectively in the operation. The nature of the stock-to-sales ratios (the inverse of net sales to inventory) is more of a management tool than an indicator of asset utilization. It can however provide some significant indications of inventory management effectiveness if combined with additional information such as out-of-stock and over-aged inventory reports. This will be briefly addressed in the concluding chapter.

J. OPERATING PERFORMANCE

The final discussion of the analysis section involves an evaluation of the operating performance of the NEX. The operating characteristics to be discussed include gross margin, net income to net worth, and the profit margin. The author also discusses the relationships of sales, gross margin, and net income.

The first characteristic, gross margin, is basically the difference between sales and the cost of goods which generated the sales. It represents the average, overall mark-on applied

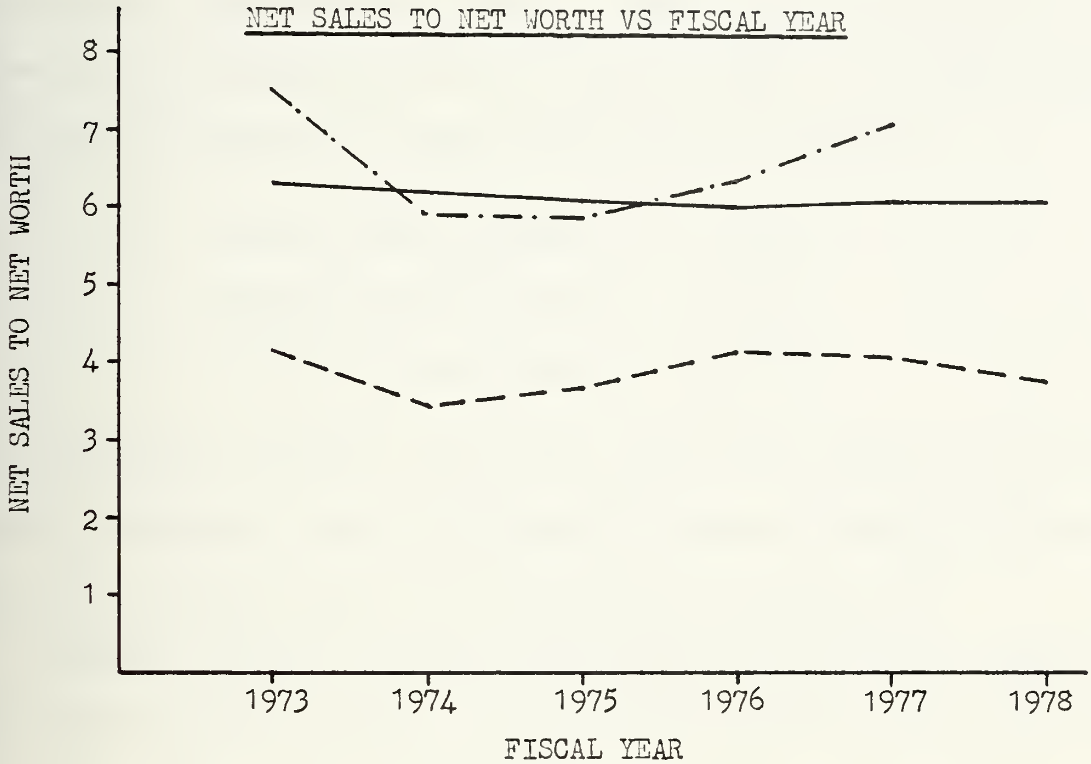


EXHIBIT III-29

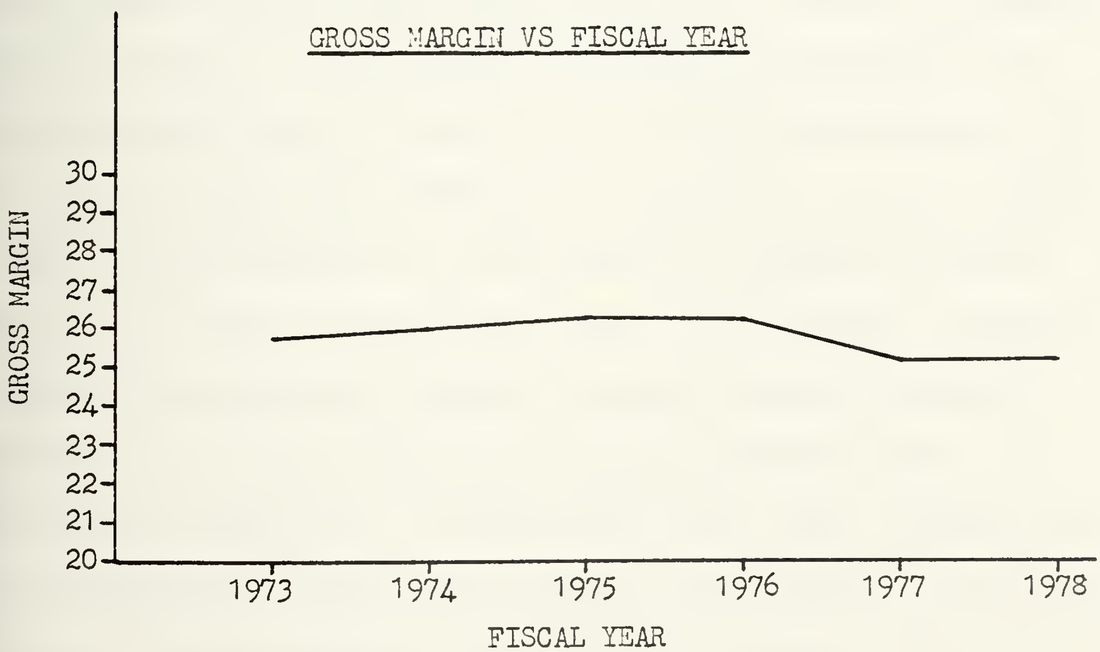


EXHIBIT III-30

to the cost of merchandise which is sold through the NEX. This overall margin is of course comprised of two differing types of NEX operations, retail and service. In fiscal year 1978, the breakdown of gross margin was as follows:

Retail Gross Margin	19.5%
Service Gross Margin	36.6%
Overall Gross Margin	25.5%

The difference between this margin and that computed by the author in Exhibit III-13 apparently results from the author's inclusion of the reserve for inventory shortage.[69]

Exhibit III-30 displays the trend line of gross margin over the six year period; it being very nearly flat with a very slight decline in 1977 followed by an equivalent gross margin in 1978. Worth noting is that NEX management implemented some pricing table adjustments and limited increased markups in Fall, 1978 which were apparently designed to increase gross margin slightly. The first indications are that these charges were effective, resulting in an overall margin of 26.1 percent in the first six months of fiscal year 1979.[70] The author feels that this increase, roughly one half of one percent change in gross margin, is most meaningful when translated back into a dollar figure. By applying an additional 0.5 percent to the 1978 computations, the NEX operation would have had an additional $5.8 million dollars in gross profit. While this is almost insignficant when discussing an operation of $1.1 billion in sales, its

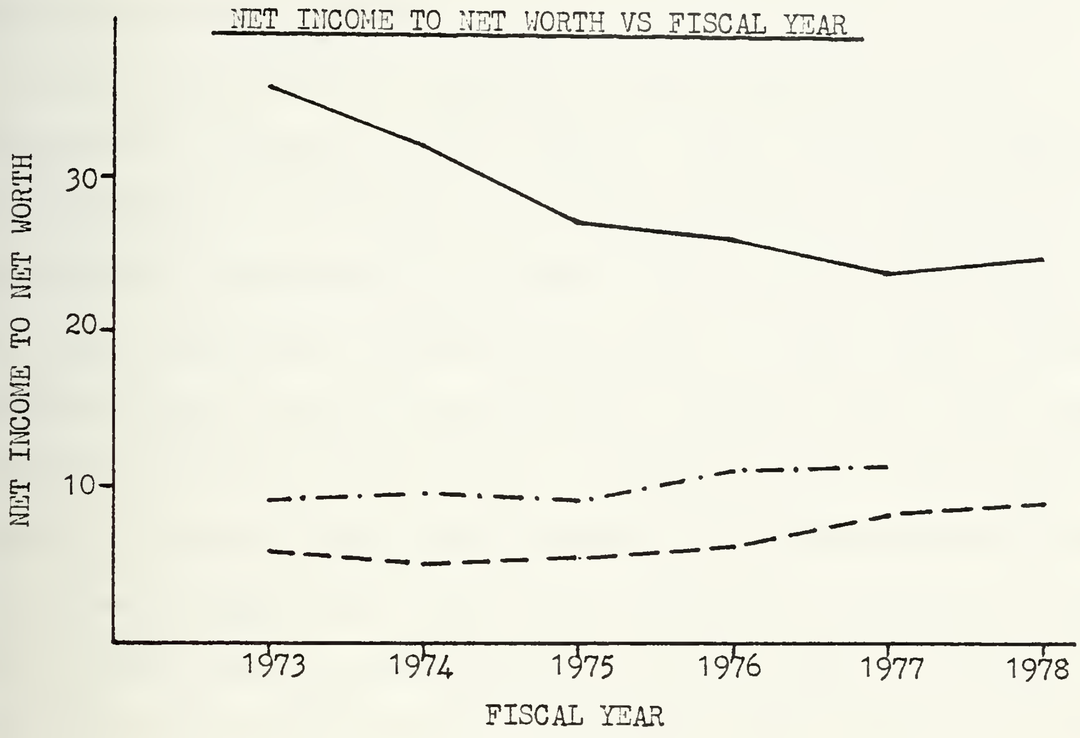


EXHIBIT III-31

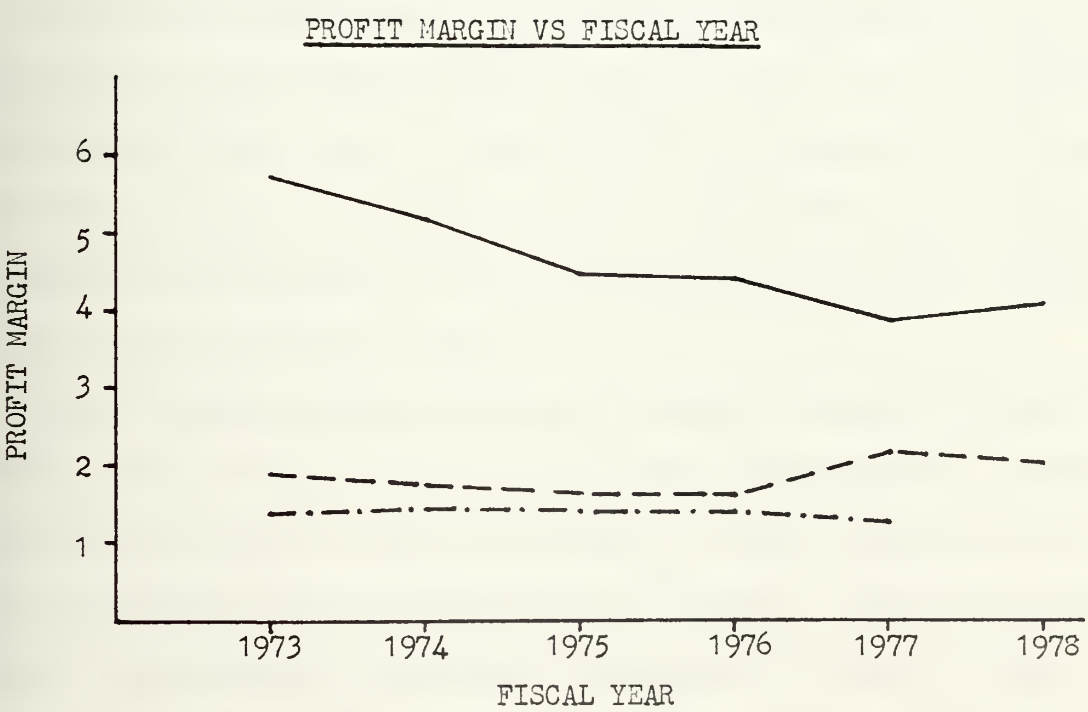


EXHIBIT III-32

magnitude becomes extremely meaningful when discussed in terms of accountability.

The reason for the increased mark-on policy is not immediately apparent to the author. Part of the 1978 decline was apparently the result of foreign currency valuations on the dollar; specifically the yen. Even at that there must be a more permanent, predictable trend in some aspect of the operation which would dictate what is apparently a new, merchandise pricing structure for the NEX Program. Two possible factors to look at are the changes in non-merchandise revenues, which would affect net sales, and inventory shortages, which would affect cost of goods sold. In any case, the author feels that the factors which motivated these pricing policy changes should be reviewed. Additional comments will be provided in the final chapter.

The second measurement of operating performance to be discussed is the ratio of net income to net worth. Displayed in Exhibit III-31, one can see the sharp decline in this ratio from 1973 to 1977. The most recent year, 1978, does provide an upturn which results from a proportionally larger increase in net income than net worth.

While the NEX ratios declined sharply for most of the period, the private sector ratios both demonstrated slightly increasing trends. This is perhaps the most significant factor presented by the analysis of this ratio. While the private sector demonstrated reasonably consistent, gradual growth, the NEX, for the most part, demonstrated a substantial reduction

in its growth performance. This characteristic is further amplified by the next measurement, profit margin.

Profit margin is the relationship of net income to net sales. It represents the income returned from each dollar of sales. As displayed in Exhibit III-32, the NEX margins are almost unanimously greater than twice as large as private sector margins. Considering the objectives of each entity and the various differences between them, such as the NEX tax advantage, the differences in the magnitude of the margins are not surprising to the author. The trend displayed over the six year period of study is viewed as significant. The NEX has experienced substantial declines in five of the six years, while the private sector has had more consistent trends with discount stores having a slight increase and department stores a marginal decrease in their profit margins.

The NEX trend is heavily influenced by both elements of the ratio, net income and net sales. While net income has consistently declined, save for 1978, net sales has consistently increased, hence a double amplification of the effect. This trend of decreasing net income and increasing net sales is considered by the author to be extremely inconsistent.

This discussion is further amplified by Exhibit III-12, which is a plot of the index numbers computed for net sales, gross profit, and net income and summarized in Exhibit III-11. The graph displays net income and net sales as widely diverging lines until 1978. Virtually the same relationship exists

between gross profit and net income. These relationships seem to indicate that the cause for the disparity occurs primarily below the gross profit line, in the NEX expense structure. Expenses have grown much more rapidly than either net sales or gross profit. A detailed analysis of the expense structure would highlight the elements most responsible for this current trend which should be of real concern to NEX management.

The upturn demonstrated in 1978 is perhaps an indication that appropriate corrective action has been taken by NEX management to curtail the downward spiral. It could also be the result of the changes in the financial environment, specifically rapidly increasing inflation. What with prices of physical goods being more susceptible to rapid adjustments than, say, wages and salaries, the upturn may simply be a function of inflation and the associated lag of certain major expense items in the financial structure of the program. These are, obviously, other possible explanations. These hypotheses will be discussed further in the next chapter.

IV. SUMMARY AND GENERAL CONCLUSIONS

A. SUMMARY

Chapter I began by introducing the Navy Exchange Program as a "big business" organization whose magnitude of operations is not properly perceived by most of the general or military populace. Further, it made comparisons to well known private sector corporations and established the exchange program's relative competitive position in the retail industry. The author then suggested that many of the fiscal characteristics of private sector retail corporations must exist within the NEX Program, including those of other than a positive nature.

Alluding to allegations presented through the press of mismanagement and corruption in the Navy Exchange Program, the author proposed that a financial analysis from a "prospective investor's" viewpoint might be enlightening. The objectives of this analysis were twofold; 1) to provide an appraisal of the current financial condition of the program, and 2) using an evaluation of performance over the period 1973 to 1978, to highlight the trends of those financial and operational indicators which may suggest changes in the program's future financial condition and viability which would be of interest to exchange management.

The author believes that these objectives were satisfied by providing a separate identity to the exchange program in

Chapter II and then applying that identity to the quantitative analysis conducted in Chapter III. The discussions following the analysis provided the author's evaluation of the results in terms of the six general financial characteristics previously referred to as the building blocks of financial analysis.

Chapter IV summarizes those financial conditions and trends of the NEX Program which the author deems most significant. In some cases problems are identified but solutions of these problems appear outside of the scope of this thesis. The summaries include interjections suggesting factors of the environment, factors of operational efficiency, or other policy decisions which may have contributed to the condition or trend.

B. GENERAL CONCLUSIONS

1. <u>Rapidly increasing accounts payable are contributing significantly to a consistently declining liquidity position</u>. Though the NEX Program currently appears to be a very liquid enterprise, it has a consistently declining trend since 1974. The accounts payable, which have increased over sixty eight percent since 1974, appear to be the driving force of the trend. Worth noting are the private sector trends which were stable to increasing in most cases during this same period of time.

This increasing trend in NEX accounts payable could be the result of a number of different factors or a combination

of all of them. It could be the result of a lengthening paperwork pipeline causing failure to pay invoices in a reasonable length of time thus contributing to discounts lost. It is interesting that purchase discounts taken during the six year span did increase as well, however, they displayed little correlation to the changes in accounts payable.

Increasing accounts payable could also be a management decision whose purpose is to use the increase of funds available in investments. By utilizing the maximum float time available within the discount period, the program can generate additional interest income. Review of the changes in interest income over the same period does not seem to support this however. Its fluctuations bear no resemblence to the payables trend.

Another possible application of increasing accounts payable is the increasing investment in inventory perhaps to support the trend of increasing sales. This appears to be partially supported by the trends demonstrated by the end-of-year inventories although there are some inconsistencies here as well, particularly the magnitude of changes of each factor.

Whatever the force motivating the accounts payable increases, the author suggests that the origin of the force is the critical factor, but specifically pinning down the individual factors is outside the scope of this thesis. Is it the result of internal planning and decision making or is it a reflection of an external force or operational inefficiency? The answer to this question should suggest what action, if any, needs to be taken.

2. <u>Rapidly increasing accounts receivable are tying up funds previously available for other investment</u>. Accounts receivable, though but a fraction of the magnitude of accounts payable, have increased at nearly twice the rate of payables. This trend provides customers the use of funds vice the NEX Program. Though the program is in no trouble whatsoever because of this increase, it is suggested that the cause of the trend is important in future decision making.

One might suggest that the increase in receivables reflects the serviceperson's declining disposable income and hence, more reliance on the NEX's one form of quasi-credit, the lay away program. This is partially supported by the accounts receivable schedule of the 1977 and 1978 detailed financial statements. This schedule is included in Appendix D.

As returned checks become receivables one might suggest a substantially increased volume of returned checks contributes to the increasing trend, which is consistent with the serviceperson's reduced disposable income. This, however, is not the case. In fact indications are that electronic verification of checks has consistently reduced this form of receivables.

Looking into the future, all other things remaining reasonably consistent, the accounts receivable for the NEX are very likely going to increase even more rapidly than current trends. This is, of course, a function of new NEX policy which provides for a deferred payment (credit) plan for personnel stationed overseas in certain geographical areas.

The success of this program may spell the primary driving force in receivables in the future.

3. Short-term investments do not appear to be consistent with interest income. One would generally expect that increasing short-term investments would lead to a similar increase in interest income. This proposed relationship does not exist within the NEX Program. As short-term investments on the balance sheets have increased over ninety percent since 1974, interest income on the statement of income has demonstrated extremely inconsistent trends with 1978 interest income being less than one percent greater than 1974 income. There is no apparent decipherable correlation between the two trends.

This may be a function of the snapshot effect on the end of the year short-term investments reported on the balance sheets. These figures represent only the investments in effect on the date of the statement while interest income is a function of these same figures as they exist each day of the accounting period. Because an in-depth analysis of cash investments was outside the scope of this thesis, the author suggests that a study of this financial realm would be enlightening.

4. NEX stock-to-sales ratios appear to be far more restrictive than those of its private sector counterparts. The research conducted determined that the NEX sales to inventory ratios were twenty to thirty percent higher than those in the private sector. This translates, through an

inverse function, to NEX stock-to-sales ratios being twenty to thirty percent lower than the private sector. To eliminate this difference in 1978, would require an NEX inventory increase of thirty to forty five million dollars.

The stock-to-sales ratios established for the NEX are upper-echelon management decisions. The author proposes that included in those concerns and goals which induce these restrictions may be a desire to keep inventories down for ease of management and/or to reduce losses, to avoid tying up funds which can be invested in other assets, and/or to allow for sufficient profit distributions. To determine whether the ratios have proven beneficial or less than beneficial, a comprehensive analysis, well beyond the scope of this research, should be conducted utilizing such information as out-of-stock statistics, over-aged inventory and markdown statistics, and inventory shortage statics and trends. Perhaps the results of such a study could be correlated to information gathered in the NEX patron attitude surveys. The author's experience in the service suggests that comments such as "The exchange never has what I want" or "The exchange always has the same thing" are common amongst personnel who infrequently use exchange facilities. These comments may be an indirect, if not a direct, function of stock-to-sales ratios.

5. Decreasing net income and increasing assets and net worth are contributing to a significant decline in NEX return on investment. The NEX has, in accordance with its mission

statement, invested millions of dollars in capital improvements over the period of study. However, the return on these investments, in measurable dollars in the form of net income, has not been realized. The leveling-off of this declining trend, which occurs from 1977 to 1978, is the first indication of the system responding to the NEX Project Budget formulation.

Prior to 1976, a formal project budget analysis including the ROI projections was not conducted to the degree it is currently being accomplished. The project budget of today is sophisticated and indications are that it may well be very accurately projecting earning potential of its projects. Rebirth of the declining trend may suggest, however, that current procedures of evaluating ROI may be biased in some manner and should be reviewed for future application.

6. Controlling gross margin levels by pricing policy may be solving only short-term problems. The research determined that the NEX overall gross margin percentage has been reasonably stable during the period of study. It also revealed that on at least one occasion, Fall 1978, adjustments to pricing tables and limited increased markons were implemented which contributed to the margin computation. The author concurs that pricing policy is undoubtedly the most utilized and easily applied control mechanism management has on gross margin, and that the aforementioned action was reasonable in view of the decline experienced by the NEX in 1976 to 1977.

However, the author's interest lies not in the fact that price increases have been utilized to maintain a stable gross margin, but instead, in those factors contributing to the necessity of such action. As mentioned in Chapter III, the author proposes that two factors are the most likely contributors: a) a decline in non-merchandise revenues, i.e., service department revenues from other than merchandise sales, and b) an increase in non-profit-generating cost of goods, i.e., inventory losses. Because NEX operating statements do not distinguish service department merchandise and non-merchandise revenues, it is difficult to directly discuss non-merchandise revenue changes. However, some overall statistics are available which may lead one to pursue further study.

The author has generated the table presented as Exhibit IV-1 from NEX operating statements from the six year period of study. From this exhibit the following generalizations can be made: a) during the period of study the retail departments' average sales growth was 3.25 percent while the service departments' was 3.70 percent. Though not conclusive, this may indicate that non-merchandise revenues in the service department <u>did not</u> decline, b) during the period of study the retail departments' gross margin increased from 17.8 to 19.9 percent with 1976 being the only decrease in six years, and c) during the same period the service departments' gross margin decreased steadily from 40.6 to 35.2 percent. Hence,

THE RELATIONSHIP OF CHANGES IN SALES
AND COST OF SALES TO GROSS MARGIN

		1978	1977	1976	1975	1974	1973
ALL DEPTS	Change in sales from previous year, %	5.85	2.08	0.33	2.07	5.02	5.11
	Change in cost of sales from previous year,%	5.77	3.51	0.40	1.76	4.54	4.62
	NEX overall gross margin, %	25.2	25.2	26.2	26.2	26.0	25.7
RETAIL	Change in sales from previous year, %	4.64	4.09	1.45	1.09	4.10	4.14
	Change in cost of sales from previous year, %	3.72	4.16	1.34	0.80	2.64	3.46
	Retail Department gross margin, %	19.9	19.2	19.1	19.2	19.0	17.8
SERVICE	Change in sales from previous year, %	8.23	(1.64)	(1.70)	3.87	6.76	6.70
	Change in cost of sales from previous year, %	10.9	1.93	(1.83)	4.06	9.51	7.77
	Service Department gross margin, %	35.2	36.8	38.4	38.9	39.0	40.6

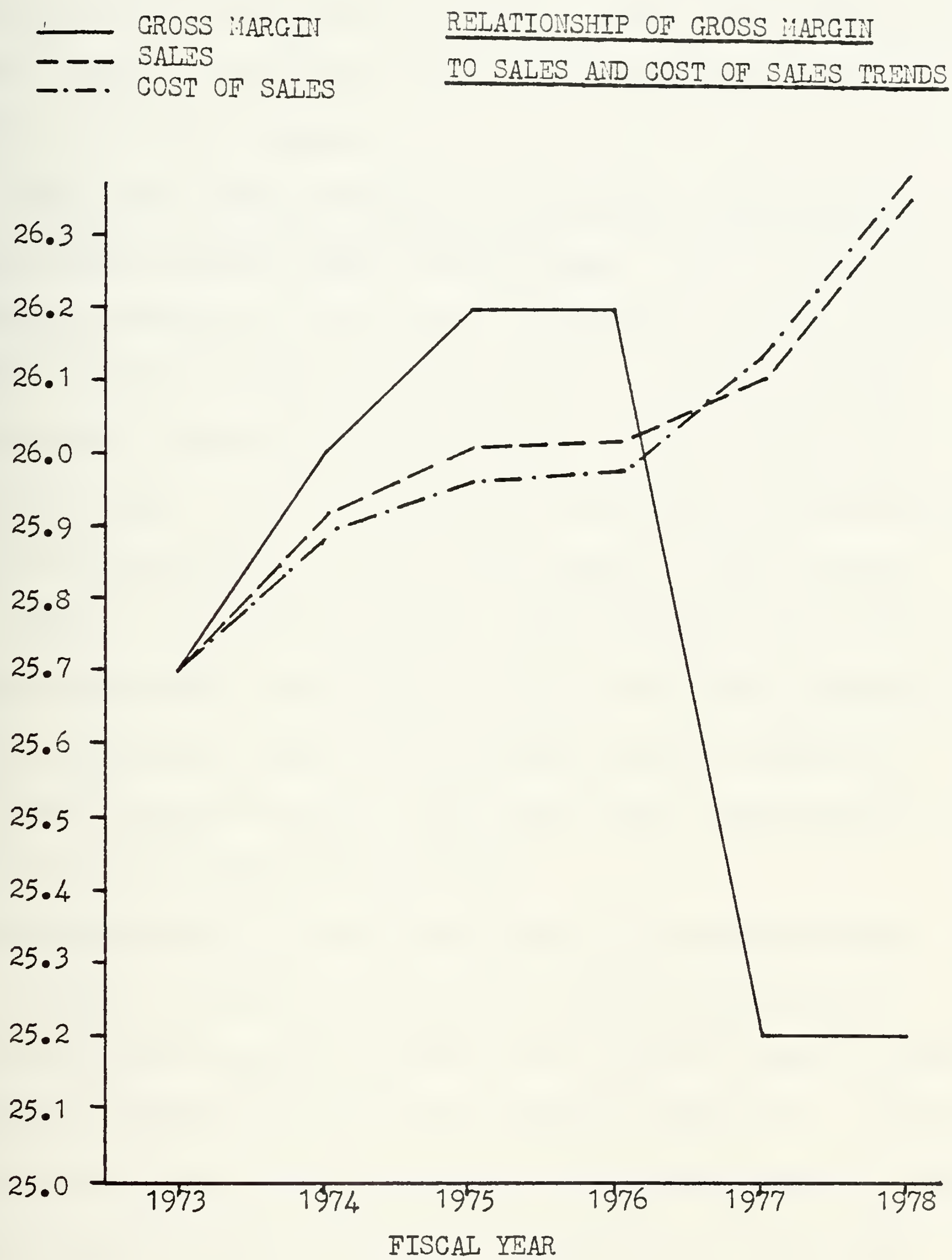
EXHIBIT IV-1

one can conclude that the service department cost of sales (cost of goods sold and inventory losses) increased much faster than its sales which may well support the second proposition.

Utilizing the statistics of "ALL DEPTS" from Exhibit IV-1, a graph has been constructed, Exhibit IV-2, which displays the relationship of gross margin to the changes in sales and cost of sales. Gross margin is plotted by its computed percentage for each year. Sales and cost of sales are plotted such that the slope of their lines from one year to the next represent their relative percentage changes during that period. For example, referring to the graph, during the period 1973 to 1974, sales increased slightly faster than cost of sales, resulting in an increased gross margin.

Perhaps the relationship of gross margin to sales and cost of sales is made most clear in the period 1976 to 1977. Here cost of sales increased substantially faster than sales resulting in a significantly reduced gross margin. During the 1977 to 1978 period, sales growth was increased to at least match cost of sales growth, hence no change in gross margin.

It appears logical to assume that the aforementioned pricing policy changes must have impacted the sales figures from 1977 to 1978. This approach to managing gross margin, though effective, may not be addressing the proper line on the graph. The cost of sales line is at least equal in importance to the gross margin trends. Perhaps another very appropriate



NOTE: Sales and cost of sales are displayed as percentage increases from year to year, at a scale of one inch to six percent.

EXHIBIT IV-2

method of maintaining the gross margin at a desirable level is to concentrate on reducing cost of sales, i.e., improving inventory control procedures and overall security measures to reduce inventory losses.

7. The trend demonstrated by net sales, gross profit, and net income are extremely inconsistent. One of the most interesting results of the author's analysis is the inconsistent relationship of sales, gross profit, and net income. As graphically demonstrated in Exhibit III-12, sales and gross profit have, for the most part, steadily increased from 1973. The inconsistency lies in the trend of net income, which, with the exception of 1978, has declined since 1973, with sharp declines from 1974 to 1977. The author proposes that this diverging trend in net income results from two likely contributing factors; relatively slow sales growth and more rapidly increasing expenses.

The issue of slow sales growth may not be immediately clear. However, statistics indicate that the NEX sales growth during this period was only one third of that of the total retail indsutry,[71] which may amplify the point. This comparison of sales growth includes adjustments for the lost revenues resulting from the Navy's decision to divest the NEX operation of enlisted clubs and package stores. These operations had accounted for twenty five to thirty five million dollars in sales annually in the early seventies.

One may suggest that increased sales requires proportionally increased expenses and hence, little change in net income percentages. At the current level of sales in the NEX,

the author found that by assuming that the current gross margin remains constant and that operating expenses remain relatively unchanged, an additional one percent increase in sales equates to approximately a six percent increase in net income. Though it may not be reasonable to assume that no changes take place in operating expenses, perhaps it is reasonable to assume that operating expenses should not increase proportionally to sales; that economies of scale must come into play eventually. There must be a large portion of administrative and other general expenses which are essentially fixed costs, remaining unchanged regardless of sales fluctuations. The changes in 1978 figures appear to support this. It is the author's contention that had sales increased more in line with the retail industry trends, the benefits of scale would have effected net income sooner and that net income would not have declined as it did.

The second contributing factor, expenses, has already been introduced in the preceeding discussion. Investigation of NEX expenses indicates that salaries, wages and employee benefits account for nearly eighty percent of all operational expenses. It is the increasing trend in these expense items that is apparently the most influential factor in the declining trend of net income. A closer look at the increasing trends of these items proves worthwhile. The author proposes three factors which may be directly related to increasing salaries, wages, and benefits: a) rate increases in salaries, wages and

benefits, b) a larger equivalent work force, and c) an inflexible work force.

Rate increases in salaries, wages, and benefits have been the driving force in expenses for the entire retail industry because of its labor intensive nature. Increases in the minimum wage laws have severely impacted personnel costs as have general scale increases implemented as a result of inflation. Research indicates that NEX labor rates have increased forty one percent since 1973. This is a substantial increase, one that has led NEX management to pursue more efficient methods of operation.

To analyze the second factor, a larger equivalent work force, NEX operating statements were utilized. These statements provide the statistic of average dollar sales per sales employee man month of labor on an annual basis. Comparing the trend of this statistic to the trend of net sales finds that it increased much more rapidly than did sales; as much as thirty times faster. This indicates improved efficiency, i.e., greater sales with fewer sales employee man months. Hence, the author concludes that it is far more likely that the sales force was reduced rather than increased. If significant increases in the NEX work force did occur, they occurred in support functions, not in direct selling personnel.

Addressing flexibility, the third factor, the author further suggests that the improved efficiency in sales personnel must result from a flexible work force; i.e., temporary

and part-time employees. From personal experience the author also suggests that administrative and other staff and support functions in a retail operation are generally less flexible than the sales force. The exchange appears to be no exception. Consider the divestiture of the enlisted clubs and package stores. It is proposed that the reduction of expenses in salaries, wages, and benefits resulting from the divestiture was less than the proportional reduction in sales. The sales force was of course eliminated, however, it is doubtful that all of the supporting staff personnel were eliminated because of their multiple responsibilities and/or need in other areas.

It should be emphasized that NAVRESSO has taken action to reduce personnel costs through a variety of programs. They have developed an improved cost control staffing program whose purpose is to adjust staffing to make higher use of part-time employees. As another aspect of their cost reduction effort, NEX management introduced complexing, grouping exchanges in certain geographical areas under one central support staff. Their newest effort is the installation and testing of the Automated Retail Management System at the Great Lakes, Illinois NEX. Once the system becomes fully operational it is expected to provide as much as a thirty percent savings in personnel costs for the NEX facility. One can see that NEX management is aggressively pursuing solutions to the problem.

8. <u>Contributions to recreation programs on a per service-person basis are declining when translated into non-inflated</u>

dollars. The NEX Program has been extremely consistent in its contributions to Navy welfare and recreation programs, particularly when compared on the basis of dollars contributed per active duty Navy person. These figures were presented in Exhibit III-4. One can see that the variance of the contributions has been extremely small with the 1978 figure of $68 being exactly the same as the 1973 contribution. Though the consistent performance is excellent, the author develops concerns regarding what the contributions are actually able to provide the Navy person from year to year what with the increasing trends in inflation. To present the discussion, the consumer price index (CPI) has been selected to compare the real dollars being contributed, and their constant dollar value.

Because of the diverse assortment of products and services provided by the NEX it was felt that the "all item" CPI would give the best overall indication of the inflation impact on the recreation contributions. The "all item" index in December, 1973 was 138.5 and increased steadily to 202.9 in December, 1978.[72] This equates to an increase in the CPI of 46.5 percent. If one applies this increase to the $68 per person contributed in 1973, it implies that approximately $100 is needed in 1978 to provide an equivalent amount of goods and services. If one accepts this argument the Navy's welfare and recreation programs would appear to be heading for difficult times. This comment is also founded on the

NEX Program's projected five year plan which estimates that the contributions to recreation programs will have increased to only $78 per Navy person in 1983.

C. CONCLUSION

The financial analysis conducted has indicated that the current financial position of the Navy Exchange Program is very sound. There are some current trends which indicate that if left unattended, the financial position in the future may, however, not be as sound. The author has highlighted in particular his concerns regarding rapidly increasing accounts payable; the apparent relationship of gross margin trends and increasing cost of sales, particularly non-profit-generating cost of sales; the divergent patterns of net sales and net income; and finally, the inflation adjusted purchasing power of the NEX contributions to the Navy's welfare and recreation programs. Indications are that any one of these individual concerns has sufficient scope for future thesis study.

The author also finds that drawing any specific conclusions from the analysis regarding the allegations of mismanagement and corruption which were alluded to in the introduction would be both unprofessional and without foundation. Proposed, however, is that some of the indicators derived from the analysis do provide the opportunity to suggest possible correlations. Much more detailed and in-depth audits of these

indicators, than time and resources permitted the author, is necessary before one could confidently draw specific conclusions.

The author concludes that if the Navy Exchange Program were available as an investment vehicle, the analysis suggests that it certainly warrants favorable consideration. The NEX Program has an excellent record and though problems do exist, none of them appear to be of sufficient magnitude to severely impact the overall operation in the near future.

APPENDIX A

NAVY EXCHANGE PATRON ATTITUDE SURVEY

A professional marketing research consultant firm conducted in-depth interviews with a scientifically selected sample of authorized patrons in five major east and west coast exchange marketing areas. A number of significant attitudinal and behavioral findings pertaining to exchange operation and service surfaced in all five marketing areas:

The Navy Exchange has a definite "store image." Authorized patrons perceive the Navy Exchange as a retail outlet that:

- Has the best prices
- Has good values for the money
- Allows easy use of personal checks
- Sells top quality goods
- Has a good return policy

The Navy Exchange is NOT perceived as having:

- Convenient shopping hours
- Lots of special sales
- Good advance notice of special sales
- Adequate parking
- Credit card or charge account usage

Patron buying patterns indicate that records/tapes, sports equipment and teenage clothing and family shoes are most often bought at commercial stores.

One of the principal objectives of this survey was to identify those segments of authorized patronage who are not exercising or who seldom exercise their Navy exchange shopping privileges. Respondents were classified into three major categories -the frequent, moderate and infrequent Navy exchange shopper. An example of survey results is as follows:

	FREQUENT NEX SHOPPER	MODERATE NEX SHOPPER	INFREQUENT NEX SHOPPER
Under 35 yrs	14%	46%	40%
35 - 54	19	46	35
55 & older	28	44	28
Active Duty*	17	45	38
Retired*	22	46	32
Enlisted*	14	46	40
Officer*	27	45	28

* Includes military personnel and their dependents.

Not only do the moderate and infrequent NEX shoppers patronize commercial retailers more often than the NEX, they also buy at a broad assortment of stores. Among infrequent shoppers, Sears and K - Mart are the principal stores that appear to better satisfy their needs and preferences.

Individual reports are being prepared for each of the five marketing areas surveyed and findings will be used to design the Navy Exchange Competitive Environment Study in which local Navy exchange management will evaluate those lines of goods and services in commercial outlets that survey findings indicate are their most serious competition.

APPENDIX B

NAVY EXCHANGE PROGRAM

FINANCIAL MANAGEMENT REPORT

MONTH OF AUGUST 1979

Prepared by
CD Division

NAVY EXCHANGE PROGRAM
OPERATIONS FOR AUGUST 1979
COMMENTS

Sales Percentage Increase or (Decrease)

	Compared to L. Y.			Compared to Plan		
	Conus	O/S	W/W	Conus	O/S	W/W
Total Sales	9.2	3.8	7.6	4.6	(7.8)	0.8
Retail Sales	6.7	2.2	5.2	3.1	(7.1)	(0.3)
Service Sales	13.1	7.7	11.9	6.7	(9.6)	2.4
L-1 Sales	15.0	15.0	15.0	14.6	15.0	14.7

1. Total Sales - Actual this year 7.6% above last year and 0.8% above plan. Worldwide retail sales increased 5.2% over last year while service sales worldwide were ahead of last year by 11.9%. Overseas sales this year are impacted by the closing of Midway, Morocco and Taipei. If these exchanges are eliminated from last year, the total Overseas sales increase of 3.8% for August 1979 becomes an increase of 6.9%. Without the unusual increase in J-3 sales this year of 22.1% worldwide service sales would have increased only 6.8%. There were 27 business days this year and last year.

2. Retail Gross Profit - Actual 0.4% above plan and 0.6% below last year which was primarily the result of higher gross profits generated in departments A2 (Tobacco and Smoking Accessories) and B-7 (Mail Order) last year.

3. Retail Direct Expense - Actual 0.5% above plan and 0.3% above last year, primarily the result of an increase of 8.7% in dollar expenses over last year of which 9.0% was in payroll and fringe benefits. This compares with a sales increase of 5.2%

4. Service Gross Profit - Actual 0.5% below plan and 0.3% over last year, primarily due to department J-3 which experienced a 2.5% increase in gross margin resulting from an increase in dollar gross margin for gasoline due to the present situation. Below plan due to lower than planned gross profits in Depts K-4 and M-2.

5. Services Direct Expense - Actual 0.9% below plan and 1.1% below last year, which is primarily due to lower expense percentages in Dept. J-3 (because of higher volume and a higher proportion of J-3 sales to total service sales this year).

6. General Expense - Payroll - The increase of $472,000 or 13.6% over last year resulted in an increase percent to sales of 0.2% above last year and 0.1% over plan.

NAVY EXCHANGE PROGRAM
OPERATING STATEMENT
MONTH ENDED 23 AUGUST 1979
(in $1,000)

	THIS YEAR				LAST YEAR	
	Financial Plan	%	Actual	%	Actual	%
Total Sales	$104,465	100.0	$105,286	100.0(1)	$ 97,833	100.0
Retail Departments						
Sales	$ 66,300	100.0	$ 66,094	100.0	$ 62,819	100.0
Gross Profit	13,190	19.9	13,444	20.3(2)	13,131	20.9
Direct Expense	5,710	8.6	6,007	9.1(3)	5,525	8.8
Net Contribution	7,480	11.3	7,437	11.3	7,606	12.1
Service Departments(excluding L-1)						
Sales	$ 37,400	100.0	$ 38,316	100.0	$ 34,253	100.0
Gross Profit	13,765	36.8	13,917	36.3(4)	12,317	36.0
Direct Expense	8,790	23.5	8,663	22.6(5)	8,130	23.7
Net Contribution	4,975	13.3	5,254	13.7	4,137	12.2
Dep. L-1 Sales	$ 765	100.0	$ 875	100.0	$ 761	100.0
Total Net Contribution	$ 12,455	11.9	$ 12,691	12.1	$ 11,793	12.1
General Expense						
Payroll	$ 3,725	3.6	$ 3,937	3.7(6)	$ 3,465	3.5
Employee Benefits	890	0.9	1,100	1.0	989	1.0
Dept. of Buildings	360	0.3	232	0.2	276	0.3
Dept. of Bldg. Improv.	170	0.2	77	0.1	91	0.1
Other	1,000	1.0	854	0.8	1,273	1.3
Sub-Total	6,145	5.9	6,200	5.9	6,094	6.2
Central Off. Exp. Net	$ 640	0.6	$ 334	0.3	$ 186	0.2
Centrally Funded Ex. Exp.	1,215	1.2	1,103	1.0	1,233	1.3
Total All Gen. Exp.	$ 8,000	7.7	$ 7,637	7.3	$ 7,513	7.7
Operating Profit	$ 4,455	4.3	$ 5,054	4.8	$ 4,280	4.4
Other Income	300	0.3	292	0.3	392	0.4
Program Net Profit	$ 4,755	4.6	$ 5,346	5.1	$ 4,672	4.8

NAVY EXCHANGE PROGRAM

OPERATION FOR 7 MONTHS ENDED 23 AUGUST 1979

COMMENTS

Sales Percentage Increase or (Decrease)

	Compared to L.Y.			Compared to Plan		
	Conus	O/S	W/W	Conus	O/S	W/W
Total Sales	9.4	2.2	7.2	2.6	(4.0)	0.6
Retail Sales	6.9	0.9	4.9	1.1	(3.9)	(0.6)
Service Sales	13.2	5.4	11.3	4.8	(4.3)	2.5
L-1 Sales	19.3	10.3	17.9	13.9	9.7	13.3

1. Total Sales - Actual 7.2% over last year and 0.6% above plan. Worldwide retail sales which increased 4.9% over last year were 0.6% below plan, while service sales Worldwide were 11.3% ahead of last year and 2.5% above plan. Without the increase on J-3 sales this year over last year of 20.7%, service sales would have increased only 6.9% over last year. If Midway, Morocco and Taipei are eliminated from last year overseas total sales, the 2.2% increase becomes an increase of 5.5%. There were 181 business days this year and last year.

2. Retail Gross Profit - Actual 0.3% above plan and 0.5% above last year which was primarily the result of increased markups in selected departments and revised pricing tables which commenced to take effect in Fall 1978.

3. Retail Direct Expense - Actual 0.6% above plan and 0.4% over last year, primarily the result of an 8.8% increase in payroll and fringe benefits over last year. Total dollar retail direct expenses increased 9.5% over last year versus an annual plan of 5.2%.

4. Service Gross Profit - Actual 0.7% below plan and 0.1% below last year. The decline in gross profit percentage was a result of lower gross margin generated in departments K-4, M-2 and M-3 due to the following:

   a. Departments K-4 (Food), M-2 (Personalized Services) and M-3 Vending Machines).

   These departments affected by currently increasing cost prices with a lag in compensating selling prices. However, due to higher dollar margin generated per gallon of gasoline starting in April 1979, J-3 profit has sharply increased, offsetting the lower J-3 gross generated in Feb. and March and offsetting the lower gross generated for total service departments.

5. Service Direct Expense - Actual 0.7% below plan and 1.0% below last year, primarily due to the lower expense percentage in Dept. J-3 because of high volume and a higher proportion of J-3 sales to total service sales.

6. General Expense - Payroll - Dollar expenses were 11.9% over last year which is considerably higher than the financial plan.

7. General Expense - Other - Actual 0.1% below plan and 0.3% below last year primarily due to higher maintenance labor credits and lower miscellaneous expenses this year.

NAVY EXCHANGE PROGRAM
OPERATING STATEMENT
7 MONTHS ENDED 23 AUGUST 1979

	THIS YEAR				LAST YEAR	
	Financial Plan	%	Actual	%	Actual	%
Total Sales	$682,200	100.0	$686,394	100.0(1)	$640,254	100.0
Retail Departments						
Sales	$434,300	100.0	$431,832	100.0	$411,731	100.0
Gross Profit	86,220	19.9	87,199	20.2(2)	81,242	19.7
Direct Expense	38,210	8.8	40,470	9.4(3)	36,974	9.0
Net Contribution	48,010	11.1	46,729	10.8	44,268	10.8
Service Departments (excl. L-1)						
Sales	$242,800	100.0	$248,786	100.0	$223,625	100.0
Gross Profit	90,035	37.1	90,621	36.4(4)	81,716	36.5
Direct Expense	59,095	24.3	58,830	23.6(5)	54,926	24.6
Net Contribution	30,940	12.7	31,791	12.8	26,790	12.0
Dept. L-1 Sales	$ 5,100	100.0	$ 5,776	100.0	$ 4,898	100.0
Total Net Contribution	$ 78,950	11.6	$ 78,520	11.4	$ 71,058	11.1
General Expense						
Payroll	$ 24,970	3.7	$ 26,095	3.8(6)	$ 23,329	3.6
Employee Benefits	6,700	1.0	7,577	1.1	6,827	1.1
Dep. of Buildings	2,520	0.4	1,712	0.2	1,846	0.3
Dep. of Bldg. Improv.	1,150	0.2	566	0.1	624	0.1
Other	6,000	0.9	5,634	0.8(7)	7,170	1.1
Sub-Total	$ 41,340	6.1	$ 41,584	6.1	$ 39,796	6.2
Central Off. Exp. Net	$ 4,205	0.6	$ 3,022	0.4	$ 3,386	0.5
Centrally Funded Ex. Exp.	7,620	1.1	7,262	1.1	6,373	1.0
Total All Gen. Exp.	$ 53,165	7.8	$ 51,868	7.6	$ 49,555	7.7
Operating Profit	$ 25,785	3.8	$ 26,652	3.9	$ 21,503	3.4
Other Income	2,100	0.3	2,357	0.3	2,434	0.4
Program Net Profit	$ 27,885	4.1	$ 29,009	4.2	$ 23,937	3.7

NAVY EXCHANGE PROGRAM
CENTRAL OFFICE EXPENSES
7 MONTHS ENDED 23 AUGUST 1979
(in $1,000)

	THIS YEAR				LAST YEAR	
	Plan	%	Actual	%	Actual	%
NAVRESSO EXPENSES						
1. Cent. Funded Ex. Exp.(1)	$ 7,620	1.1	$ 7,262	1.1	$ 6,373	1.0
2. For Central Office (2)	$11,120	1.6	$11,187	1.6	10,054	1.6
Less: Other Income (3)	6,915	1.0	8,165	1.2	6,668	1.0
Cent. Off. Exp.-Net	$ 4,205	0.6	$ 3,022	0.4	$ 3,386	0.5
Total NAVRESSO Expense	$11,825	1.7	$10,284	1.5	$ 9,759	1.5

NAVY EXCHANGE PROGRAM
CENTRAL OFFICE EXPENSE

COMMENTS

1. Centrally Funded Exchange Expense - Actual same as plan and 0.1% higher than last year which is primarily the result of increases in Group Insurance Plan costs.

2. For Central Office - This year $1,133,000 higher than last year reflecting increases in payroll and equipment depreciation.

3. Other Income - Actual 0.2% above plan and last year, a result of higher interest income. This is due to higher rates and the availability of more investable funds due to the implementation in June 1978 of a new precedure whereby prepaid vendor invoices are now paid on a due date basis.

NAVY EXCHANGE PROGRAM
PORTION OF PROFITS REINVESTED IN PROGRAM
AND PROFITS AVAILABLE FOR DISTRIBUTION

COMMENTS

1. NAVRESSO NOTICE 7320 of 16 March 1979, established the reinvested percentage to be used against exchange net profits by sales groups. These percentages were within the parameters developed for the financial plan average of 28.4% with a peak of 30.0%. As noted below, net program profit for the seven months ending August 1979 surpassed the plan, and since there were operating losses of $1,435,000 with retention applicable to profits only, a higher profit total was arrived at for retention purpose. The following schedule presents these factors accordingly:

	Plan	T. Y.	L. Y.
Net Program profits (Excl. L-1)	$27,885	$29,009	$23,937
Less: (Under) Over Applied Expenses	-	2,704	1,259
Net Profit per Operating Statement (Excl. L-1)	$27,885	$26,305	$22,678
Add: Net Operating losses	-	(1,435)	(1,126)
Net Profit upon which retention is based (A)	$27,885	$27,740	$23,804
Exchange Reinvested per Operating Statement (A)	$ 7,920	$ 7,421	$ 5,141
Add: (Under) Over applied expenses	-	2,704	1,259
	$ 7,920	$10,125	$ 6,400
(A) Average % of Exchange Reinvestment Per Operating Statement to Net Exchange Profits	28.4%	26.8%	21.6%

NAVY EXCHANGE PROGRAM
PORTION OF PROFITS REINVESTED IN PROGRAM
AND PROFITS AVAILABLE FOR DISTRIBUTION
7 MONTHS ENDED AUGUST 1979
(in $1,000)

	THIS YEAR		LAST YEAR
	Plan	Actual	Actual
Net Program Profit	$27,885	$29,009	$23,937
Less:			
Provision for Food Processing	$ -0-	$ 97	$ (61)
Mail Order Profits Distributed	350	144	392
	$ 350	$ 241	$ 331
Balance	$27,535	$28,768	$23,606
Reinvested in Program (1)	7,920	10,125	6,400
Net Operating Losses-Current Yr.	-0-	(1,435)	(1,126)
Net Retained for Reinvestment	$ 7,920	$ 8,690	$ 5,274
Balance to Recreation Funds	$19,615	$20,078	$18,332
% of Reinvested in Program to Net Program Profit (1)	28.4%	34.9%	26.7%

NAVY EXCHANGE PROGRAM
BALANCE SHEET COMPARISON
AS AT 23 AUGUST 1979
(in $1,000)

	LAST YEAR Actual Aug 1978	THIS YEAR Actual Aug 1979	THIS YEAR Plan Aug 1979	Increase (Decrease) Actual/Plan	
Current Assets					
Cash & Equivalents	$ 35,158	$ 42,978	$ 41,160	$ 1,818	(1)
Accounts Receivable	14,519	16,889	16,600	289	
Inventories-On Hand	150,646	166,418	156,700	9,718	
Inventories-In Transit	25,744	27,872	20,500	7,372	
Total Inventories Net	176,390	194,290	177,200	17,090	(1)
Prepaid Expenses	4,208	5,189	4,800	389	
Total Current Assets	$230,275	$259,346	$239,760	$19,586	
Funded Reserves	$ 11,613	$ 11,495	$ 11,700	$ (205)	
Long Term Loan-Navy Ldge. Prog.	1,250	1,178	1,200	(22)	
Securities on Deposit	499	499	500	(1)	
Fixed Assets (Net):					
Buildings	15,335	17,995	23,405	(5,410)	(1)
Building Improvements	7,320	9,006	9,220	(214)	(1)
Equipment	24,053	23,707	24,635	(928)	(1)
Due from BuPers E Club Transfers	3,401	3,289	3,150	139	
Total Assets	$293,746	$326,515	$313,570	$12,945	
Current Liabilities					
Accounts Payable-Vendors	$ 72,515	$ 85,795	$ 73,800	$11,995	(1)
Other Current Liabilities	27,894	33,594	33,150	444	
Total Current Liabilities	$100,409	$119,389	$106,950	$12,439	
Offset for RCS Cons. Inv. included with On Hand Inventories	$ 4,735	$ 5,504	$ 5,500	$ 4	
Indigenous Retirement Funded	$ 6,613	$ 6,495	$ 6,700	$ (205)	
Net Assets					
Appropriated For:					
Self-Insurance Funded	$ 5,000	$ 5,000	$ 5,000	$ -	
Sub-Total	$ 5,000	$ 5,000	$ 5,000	$ -	
Unappropriated					
Net Assets Acquired	$ 19,951	$ 19,951	$ 20,000	$ (49)	
Reinvested Earnings	151,589	161,486	161,500	(14)	
Current Reinv. in Program	5,449	8,690	7,920	770	
Sub-Total	$176,989	$190,127	$189,420	707	
Total Net Assets	$181,988	$195,127	$194,420	707	
Total Liab., Res., &Net Assets	$293,746	$326,515	$313,570	$12,945	

COMMENTS ON VARIANCES FROM FINANCIAL PLAN

1. The increase in Cash and Equivalents from the plan is primarily the result of an increase in accounts payable vendors (primarily related to inventory increase) and a net decrease in expenditures of fixed assets offset by increases in Net Inventories.

NAVY EXCHANGE PROGRAM
STANDARD BALANCE SHEET RATIOS
AS AT 23 AUGUST 1979
(in $1,000)

	Last Year	This Year	
	Actual	Actual	Plan
Working Capital	$129,866	$139,957	$132,810
Current Ratio	2.29-1	2.17-1	2.24-1
Cash & Equivalents to Vendor Liabilities	.48-1	.50-1	.56-1
% On Hand Inventory to Working Capital	116.0%	118.9%	118.1%
% Total Inventory to Working Capital	135.8%	138.8%	138.4%

NAVY EXCHANGE PROGRAM
WORLDWIDE BOM INVENTORIES
(in $1,000)

Retail Departments
BOM September

	Financial Plan		Open-to-Buy Plan		Actual	
	Inventory	S/S Ratio	Inventory	S/S Ratio	Inventory	S/S Ratio
August	$161,300	2.43	$168,041	2.48	$175,798	2.66
September	167,700	2.60	174,990	2.60	182,975 (1)	
October	167,900	2.54	190,303	2.77		
November	176,500	2.42	205,113	2.67		
December	179,000	1.79	185,815	1.76		

Retail BOM September 1979 Number of Months Supply

				No. of Months Stock	
				Est.	Actual
	On Hand	On Order	Total	This Year	Last Year
Worldwide	$182,975	$109,680	$292,655	-	-
Continental	116,456	61,016	177,472	3.4	3.4
Overseas	66,519	48,664	115,183	5.2	5.9

Retail Departments Stock Turn
7 Months ended August 1979

	This Year		Last Year
	Plan	Actual	Actual
Continental	2.98	2.81	2.87
Overseas	2.52	2.24	2.51
Worldwide	2.81	2.60	2.74

Worldwide BOM Inventories
Service Departments

	Financial Plan		Actual *	
	Inventory	S/S Ratio	Inventory	S/S Ratio
August	$22,900	.61	$23,887	.62
September	23,300	.67	24,408	
October	22,700	.70		
November	22,800	.69		
December	23,200	.65		

* Actual Services Inventories exclude Dept. L-1 ($5506 EOM July $5548 EOM August)

COMMENTS

1. Retail Inventory - BOM September retail inventory in Conus was $5,672,000 or 5.1% over the open-to-buy plan, while Overseas retail inventory was $2,312,000 or 3.6% over the open-to-buy plan for a total net increase of $7,984,000 or 4.6% at retail.

NAVY EXCHANGE PROGRAM
SOURCE AND USE OF FUNDS
7 MONTHS ENDING 23 AUGUST 1979
(In $1,000)

		Plan		Actual
Opening Balance-Cash & Equivalents		$48,895		$48,895
Sources				
Profits Reinvested in Program	$ 7,920		$ 8,690	
Depreciation of Equipment	5,700		4,844	
Depreciation of Buildings	2,520		1,712	
Depreciation of Bldg. Improv.	1,150		566	
Decrease in Accounts Receivable	1,785		1,495	
Increase in Other Current Liab.	3,020		3,401	
Decrease in Misc. Other Assets	265		148	
Increase in Vendors Payable	7,650		19,643 (1)	
Offset for RCS Consignment Inv.	330		334	
Total Sources		$30,340		$40,833
Uses				
Increases in Inventories - Net	$21,050		$38,140 (1)	
Equipment Expenditures	5,950		4,166	
Building Expenditures	8,410		2,190	
Building Improvement Expenditures	2,410		1,609	
Increase in Misc. Prepaid Expenses	255		645	
Total Uses		$38,075		$46,750
Net Increase (Decrease) in Funds		(7,735)		(5,917)
Cash & Equivalents As At 23 Aug. 1979		$41,160		$42,978

COMMENTS

1. The increase in Vendors Payables over the plan is partially related to an increase of inventories over the plan. However, there are number of exchanges that have higher accruals this year than last year.

APPENDIX C

NAVY EXCHANGE PROGRAM
COMPARATIVE OPERATING STATEMENT
FOR THE PERIOD ENDING 21 JANUARY 1979 AND 22 JANUARY 1978

	FOR 12 MONTHS ENDING			
	21 JAN 79	%	22 JAN 78	%
SALES				
RETAIL DEPARTMENTS	743,687,991	65.5	710,733,724	66.2
SERVICE DEPARTMENTS	392,097,121	34.5	362,268,055	33.8
TOTAL SALES	1,135,785,112	100.0	1,073,001,779	100.0
LESS: COST OF SALES				
RESERVE FOR INVENTORY SHORTAGES	6,670,135	.6	6,377,187	.6
COST OF MDSE AND MATERIALS	843,005,440	74.2	796,824,783	74.3
TOTAL COST OF SALES	849,675,575	74.8	803,201,970	74.9
GROSS PROFIT	286,109,537	25.2	269,799,809	25.1
LESS: DIRECT EXPENSE				
DEPRECIATION EXPENSE-EQUIPMENT	6,084,018	.5	6,480,933	.6
PAYROLL EXPENSE	103,404,389	9.1	97,859,226	9.1
EMPLOYEE BENEFITS	27,758,746	2.4	26,108,532	2.4
STATIONERY AND SUPPLIES	3,161,864	.3	2,980,129	.3
REPAIRS AND MINOR REPLACEMENT	5,914,399	.5	5,015,016	.5
UTILITIES	5,622,918	.5	4,693,261	.4
MISCELLANEOUS	9,104,957	.8	8,143,500	.8
TOTAL DIRECT DEPT EXPENSE	161,051,291	14.2	151,280,597	14.1
NET CONTRIBUTION	125,058,246	11.0	118,519,212	11.0
LESS: EXCHANGE GENERAL EXPENSE				
ADINISTRATIVE-PAYROLL	17,780,521	1.6	16,571,458	1.5
EMPLOYEE BENEFITS & FICA TAXES	3,833,241	.3	3,755,908	.4
WAREHOUSE-PAYROLL	12,261,688	1.1	11,452,473	1.1
EMPLOYEE BENEFITS & FICA TAXES	3,698,064	.3	3,329,496	.3
MAINTENANCE-PAYROLL	5,065,124	.4	4,679,050	.4
EMPLOYEE BENEFITS & FICA TAXES	1,584,193	.1	1,438,567	.1
PERSONNEL -PAYROLL	1,651,395	.1	1,505,928	.1
EMPLOYEE BENEFITS & FICA TAXES	510,829	.0	455,618	.0
SECURITY-PAYROLL	3,303,306	.3	2,936,101	.3
EMPLOYEE BENEFITS & FICA TAXES	805,608	.1	702,556	.1
STATIONERY AND SUPPLIES	1,426,781	.1	1,333,903	.1
REPAIRS & REPLACEMENTS	3,816,004	.3	3,506,586	.3
DEPRECIATION EXP-BLDG IMPROVEMENTS	1,095,573	.1	1,114,974	.1
DEPRECIATION EXP-BUILDINGS	3,143,660	.3	3,190,482	.3
DEPRECIATION EXP-EQUIPMENT	1,870,066	.2	2,359,806	.2
AUTOMOTIVE-NESC	46,855	.0	65,573	.0
UTILITIES	1,669,773	.1	1,383,417	.1
FREIGHT & EXPRESS	171,500	.0	197,023	.0
CASH SHORT OR (OVER)	203,347	.0	243,819	.0
TRAVEL	894,126	.1	861,541	.1
TELEPNONE TELEGRAPH & POSTAGE	1,880,513	.2	1,724,214	.2
MISC. GENERAL EXP-RETURNED CHECKS	330,177	.0	276,711	.0
MISC. GENERAL EXP-CONVERSION DIFF. FGN	(424,400)	(.0)	1,022,243	.1
MISC. GENERAL EXP-EQUIPMENT RENTAL	957,054	.1	641,761	.1
MISC. GENERAL EXP-MAINT LABOR CHARGES	(4,654,946)	(.4)	(3,757,676)	(.4)
MISC. GENERAL EXP-OTHER	4,131,339	.4	3,709,802	.3
TOTAL EXCHANGE GENERAL EXPENSES	67,051,391	5.9	64,701,334	6.0
OPERATING PROFIT BEFORE OTHER INCOME	58,006,855	5.1	53,817,878	5.0

NAVY EXCHANGE PROGRAM
COMPARATIVE OPERATING STATEMENT
FOR THE PERIOD ENDING 21 JANUARY 1979 AND 22 JANUARY 1978

	FOR 12 MONTHS ENDING			
	21 JAN 79	%	22 JAN 73	%
ADD: EXCHANGE OTHER INCOME				
PURCHASE DISCOUNTS	933,979	.1	1,023,516	.1
MISCELLANEOUS INCOME	2,829,053	.2	2,718,863	.3
INCOME FROM CONCESSIONS	42,528	.0	42,732	.0
INCOME FROM MONEY ORDERS & TRAVEL CKS	101,881	.0	86,813	.0
TOTAL EXCHANGE OTHER INCOME	3,907,441	.3	3,871,925	.4
NET EXCHGE PROFIT BEFORE NAVRESO CHGES	61,914,296	5.5	57,689,804	5.4
LESS: NAVRESO CENTRAL OFFICE EXP AND NAVRESO EXP FOR EXCHANGES				
NAVRESO CENTRAL OFFICE EXP				
PAYROLL	12,511,100	1.1	11,608,770	1.1
TAXES-FICA	673,567	.1	595,653	.1
RETIREMENT ANNUITY CONTRIB	1,526,134	.1	1,401,311	.1
PROVISIONS FOR VAC & TERMINATION PAY	1,179,292	.1	1,074,140	.1
TELEPHONE AND TELEGRAPH	471,960	.0	416,643	.0
POSTAGE	127,441	.0	99,743	.0
SUBSCRIPTIONS & PERIODICALS	17,592	.0	19,159	.0
MACHINE RENTALS	568,610	.1	567,555	.1
STATIONERY & SUPPLIES-NAVRESO	286,418	.0	292,105	.0
FORMS & CARDS-DP-NAVRESO	165,906	.0	146,078	.0
REPAIRS & MINOR REPLACEMENTS	120,106	.0	(52,635)	(.0)
EMPLOYMENT EXPENSE	19,455	.0	31,977	.0
EMPLOYEES COMPLAINT/GRIEVANCE	1,303	.0	354	.0
EMPLOYEE BENEFITS-EDUCATION	71,289	.0	46,435	.0
EMPLOYEE BENEFITS-OTHER	68,603	.0	58,758	.0
TRAINING AIDS	21,094	.0	25,768	.0
TRAVEL-FIELD ASSISTANCE	826,908	.1	766,578	.1
TRAVEL-FIELD AUDIT/INSPECTION	284,865	.0	289,553	.0
TRAVEL-FIELD WORKSHOP/SEMINARS	111,657	.0	115,248	.0
TRAVEL-S/S AFLOAT PERSONNEL				
NAVY EXCHG MANAGEMENT COURSE COSTS	7,000	.0	7,199	.0
NAVY EXCHG TRAVEL CLEARANCE A/C	6,529	.0	(5,554)	(.0)
DEPRECIATION EXP-(NRSO EQUIP)	489,046	.0	338,504	.0
UTILITIES	11,935	.0	12,652	.0
JANITORIAL SERVICE & SUPPLIES	18,063	.0	12,064	.0
PREMIUM TIME SPACE CHARGES	50,888	.0	33,197	.0
DOD NAF SALARY WAGE GROUP	88,350	.0	99,792	.0
PROFESSIONAL SERVICES	181,405	.0	222,594	.0
CONTRACT EMPLOYEES-KEYPUNCH	36,751	.0	33,953	.0
GASOLINE & AUTOMOTIVE	7,181	.0	8,094	.0
MISCELLANEOUS EXPENSES	9,166	.0	8,868	.0
ADVISORY COMMITTEE EXPENSE	28,791	.0	51,093	.0
REIMBURSABLE PAYROLL-COMSYSTO/SS	(2,009,202)	(.2)	(1,809,922)	(.2)
REIMBURSABLE PAYROLL-NUD (RCS)	(235,497)	(.0)	(137,843)	(.0)
REIMBURSABLE TRAVEL-COMSYSTO/SS	(147,982)	(.0)	(153,189)	(.0)
REIMBURSABLE TRAVEL -NUD (RCS)	(11,473)	(.0)	(15,669)	(.0)
REIMBURSABLE OTHER EXP-COMSYSTO/SS/NUD	(54,182)	(.0)	(52,117)	(.0)
REIMB TOH EXP NUD			(10,581)	(.0)
TOTAL NAVRESO CENTRAL OFF EXP	17,530,069	1.5	16,146,[illegible]	1.5

NAVY EXCHANGE PROGRAM
COMPARATIVE OPERATING STATEMENT
FOR THE PERIOD ENDING 21 JANUARY 1979 AND 22 JANUARY 1978

	FOR 12 MONTHS ENDING			
	21 JAN 79	%	22 JAN 78	%
LESS: OTHER INCOME				
SERVICE CHARGE-DP	32,787	.0	82,696	.0
SERVICE CHARGE-US COAST GUARD	7,800	.0	7,800	.0
SERVICE CHARGE -NAVY LODGES	105,869	.0	99,585	.0
SERVICE CHARGE-MSC EXCHG	26,133	.0	23,386	.0
INTEREST INCOME	2,964,440	.3	1,893,661	.2
GAIN (LOSS)-U.S. INVESTMENTS	(11,633)	(.0)	116,525	.0
PURCHASE DICOUNTS TAKEN	7,432,281	.7	7,320,724	.7
MISCELLANEOUS INCOME	715,310	.1	652,345	.1
RETAIL INV INCENTIVE PLAN INCOME	436,886	.0	271,505	.0
TOTAL OTHER INCOME	11,709,873	1.0	10,473,227	1.0
NET CENTRAL OFFICE EXPENSES	5,820,196	.5	5,673,093	.5
NAVRESO EXPENSE FOR EXCHANGES				
GROUP INSURANCE PLAN CONTRIBUTIONS	4,247,954	.4	3,807,150	.4
NEX MGMT COSTS SUBSID-NAVRESO	69,803	.0	172,331	.0
CAREER MANAGEMENT	274,119	.0	305,250	.0
EXECUTIVE MANAGEMENT PROGRAM EXPENSES	855,769	.1	413,696	.0
PROVISION FOR EMPL DEATH BENEFITS-L/N	6,730	.0	2,892	.0
EMPLOYEE SAFETY INCENTIVE PROGRAM	27,398	.0	37,069	.0
STATIONERY & SUPPLIES-EXCHGES	678,904	.1	676,729	.1
NAVRESO SAFETY & FIRE PROTECT PROGRAM	13,895	.0	12,413	.0
DISPLAY MATERIAL	297,306	.0	242,259	.0
FREIGHT & EXPRESS-NAVRESO	52,163	.0	49,576	.0
FREIGHT & EXPRESS-EXCHANGES	21,220	.0	16,037	.0
FREIGHT & EXPRESS-OVERPACKING	17,352	.0	4,397	.0
TRAFFIC MANAGEMENT SERVICES (NET)	22,464	.0	67,891	.0
CASH REGISTER MAINTENANCE EXP	517,485	.0	444,583	.0
INSURANCE EXP-UNDERWRITERS	314,867	.0	277,531	.0
INSURANCE EXP-SELF INSURANCE	2,710,437	.2	2,666,404	.2
EXCHANGE CHARGE-WORKERS COMP	(45,919)	(.0)	(42,287)	(.0)
CONVERSION DIFF ABSORBED-NRSO	(154,186)	(.0)	(1,347)	(.0)
EPA BEVERAGE CONTAINERS-SUPPLIES			11,790	.0
EPA BEVERAGE CONTAINERS-PROFIT SUBID	92,199	.0	70,796	.0
DEPRECIATION EXP-BLDG	79,448	.0	88,690	.0
DEPRECIATION EXP-BLDG IMPROV			191,414	.0
INVENTORY REVALUATION EXPENSE	340,949	.0	570,102	.1
EXCHANGE (PROFITS) OR LOSSES ABSORBED	631,443	.1	1,300,074	.1
PROVISION FOR BAD DEBTS	104,965	.0	26,120	.0
RESEARCH & DEVELOPMENT -DP	186,951	.0	216,549	.0
RESEARCH & DEVELOPMENT-PT OF SALE	26,173	.0	52,135	.0
RESEARCH & DEVELOPMENT-ARMS	85,743	.0		
RESEARCH & DEVELOPMENT-A/P	12	.0		
RESEARCH & DEVELOPMENT-OTHER	21,800	.0	316	.0
APPRAISAL EXPENSE	8,586	.0	7,414	.0
FLEET ASSISTANCE TEAM NAPLES	32,477	.0	30,290	.0
(GAIN) OR LOSS ON SALE OF FIXED ASSETS				.0
TOTAL NAVRESO EXP FOR EXCHANGES	11,538,507	1.0	11,718,264	1.1
TOTAL CENT OFF & EXP FOR EXCH	17,358,703	1.5	17,391,357	1.6

NAVY EXCHANGE PROGRAM
COMPARATIVE OPERATING STATEMENT
FOR THE PERIOD ENDING 21 JANUARY 1979 AND 22 JANUARY 1978

	FOR 12 MONTHS ENDING			
	21 JAN 79	%	22 JAN 78	%
NET PROGRAM PROFIT BEFORE REIMBUR-RCS	44,555,593	3.9	40,298,447	3.8
ADD:RETAIL CLOTHING STORE LOSSES	1,694,968	.1	1,510,746	.1
NET PROGRAM PROFIT	46,250,561	4.1	41,809,193	3.9

	FOR 12 MONTHS ENDING			
	21 JAN 79	%	22 JAN 78	%
NET PROFIT PER EXCHGE OPERATING STATE	43,359,716	3.8	41,440,957	3.9
ADD: RETAIL CLOTHING STORE LOSSES	1,694,968	.1	1,510,746	.1
SUB-TOTAL	45,054,684	4.0	42,951,703	4.0
EXCESS NAVRESO EXP CHGED TO EXCHGES				
NAVRESO EXP CHGED TO EXCHANGES	6,816,460	.6	6,430,702	.6
CENTRALLY FUNDED EXP CHGED TO EXCHANGE	11,738,120	1.0	9,818,145	.9
TOTAL EXPENSES CHANGED TO EXCHANGES	18,554,580	1.6	16,248,847	1.5
ACTUAL EXPENSES	17,358,703	1.5	17,391,357	1.6
(UNDER)/OVER APPLIED EXPENSE	1,195,877	.1	(1,142,510)	(.1)
NET PROGRAM PROFIT	46,250,561	4.1	41,809,193	3.9

	FOR 12 MONTHS ENDING			
	21 JAN 79	%	22 JAN 78	%
DIST OF NET PROGRAM PROFIT				
LOCAL RECREATION FUNDS PAID/PAYBLE	18,532,163	40.1	19,534,566	46.7
CENTRAL RECREATION FUNDS PAID/PAYABLE	17,505,588	37.8	18,389,228	44.0
PROVISION FOR FOOD PROCESSING	(66,753)	(.1)	(57,007)	(.1)
MAIL ORDER PROFITS PAID/PAYABLE	475,167	1.0	1,047,627	2.5
NET PROFITS REINVESTED IN PROGRAM	11,514,448	24.9	4,416,770	10.6
NET OPERATING (LOSSES) CURRENT YEAR	(1,710,052)	(3.7)	(2,008,548)	(4.8)
PROVISION FOR E CLUB ENTERTAINMENT			(617,110)	(1.5)
E CLUB PROF			1,103,667	2.6
TOTAL	46,250,561	100.0	41,809,193	100.0

APPENDIX D

NAVY EXCHANGE PROGRAM
SCHEDULE TO BALANCE SHEET
As At 21 January 1979 and 22 January 1978

	FINAL AUDITED STATEMENT	
Schedule 1		
Analysis of Accounts Receivable	21 Jan 79	22 Jan 78
Due from customers on open accounts	9,415,000	6,234,000
Due from customers on lay-away	4,047,000	2,986,000
Retail clothing store operating costs reimbursed	441,000	1,837,000
Returned checks	221,000	249,000
Claims and other receivables	4,410,000	1,640,000
Due from vendors	771,000	933,000
Due from Navy Lodge—current portion	75,000	-
Due from Bupers E Club Transfers—current portion	500,000	-
	19,880,000	13,879,000
Less: Allowance for bad debts	150,000	150,000
TOTAL ACCOUNTS RECEIVABLE	19,730,000	13,729,000
Schedule 2		
Analysis of Reinvested Earnings		
Prior years reinvested earnings	140,699,000	140,532,000
Return of appropriated amounts to reinvested earnings as per advisory committee in May 78	10,889,000	-
Net profits reinvested current year	11,514,000	4,416,000
Net (Losses) absorbed current year	(1,710,000)	(2,008,000)
Current year losses recovered from prior year profits not distributed (NEDCO)	24,000	-
Current year losses recovered from current year excess inventory reserve	69,000	-
Net (Losses) E Club entertainment current year	-	(617,000)
TOTAL REINVESTMENT IN PROGRAM	161,485,000	142,323,000

APPENDIX E

GLOSSARY OF TERMS

1. bumboat - A civilian boat selling supplies, provisions, and other articles to the crews of ships. Supposedly derived from "boomboat" signifying a boat permitted to lie at the ship's booms.

2. commissary store - Food store for military personnel. The lower prices at such stores are among the fringe benefits taken into account when military pay scales are established.

3. expense center - An activity whose financial performance is measured only in terms of expenses; a non-revenue producing activity given a specified budget within which it must operate. Most government activities fulfill this definition.

4. general order - A numbered directive of a general nature and wide application issued by the Navy Department and signed by the Secretary of the Navy.

5. hurdle rate - The minimum rate of expected return on investment accepted by an enterprise for proposed projects or business ventures.

6. markdowns - Merchandise priced below the normal retail price as a result of its age, slow sales movement, and/or physical condition.

7. mark-on - The amount added to the cost of merchandise purchased by an enterprise to arrive at the retail or selling price of the merchandise.

8. muster - roll call, accounting for personnel assigned to an activity.

9. Navy exchange - A store for naval personnel and their dependents that sells at a small profit for the benefit of the welfare and recreation fund.

10. purser - English: An officer appointed by the Lords of the Admiralty to take charge of the provisions of a ship of war, and to see that they are carefully distributed to the officers and crew according to the instructions which he has received from the Commissioners of the Navy for that purpose. American: A commissioned officer who has charge of the provisions, clothing, etc., and of the public monies on board ship.

11. repurchase agreements - Investment vehicles where the investment firm provides notes, bonds, or other commercial paper as collateral for cash and agrees to repurchase the collateral upon request from the investing firm.

12. revenue center - An activity whose financial performance is measured in terms of both expenses and revenues generated; the non-profit sector's equivalent to the profit center of the private sector. The Navy exchange may be considered a revenue center.

13. slops chest - A locker belonging to the officer who sold articles of clothing to crew members, charging it against their wages. Since such an officer - usually the ship's purser - sometimes considered his slops chest as a device to augment his income, his stock had a tendency to be of poor quality and very expensive, and the whole institution was much resented even when honestly run.

14. small stores - A government operated shop on a base or large ship which stocks standard articles of uniforms for officers and enlisted men with such related articles as buttons, brushes, etc.

15. stock-to-sales ratio - The amount of inventory, in dollars, allowed for each dollar's worth of sales generated, usually specified by product or department.

APPENDIX F

GLOSSARY OF ABBREVIATIONS

AAFES	Army-Air Force Exchange System
ASER	Armed Services Exchange Regulations
CO	Commanding Officer
CONUS	Continental United States
CSO	Commissary Store Officer
DOD	Department of Defense
NAVRESSO	Navy Resale and Services Support Office
NAVRESSREG	Navy Resale and Services Support Region
NAVSUP	Naval Supply Systems Command
NEX	Navy Exchange
NEO	Navy Exchange Officer
NRSO	Navy Resale Systems Office
RCS	Retail Clothing Stores
ROI	Return on Investment

FOOTNOTES

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[10]Naval Armament Act of March 3, 1909.

[11]Naval Armament Act of June 24, 1910, Ch. 378, 36 Stat., 605.

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[37]"AAFES Kills Credit Card Idea," Air Force Times, September 26, 1977, p. 2.

[38]"Navy Exchanges Testing Credit O'Seas," Navy Times, December 10, 1979, p. 2.

[39]Navy Resale and Services Support Office, Navy Exchange Procurement Manual, para. 2-106.

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